Bloomberg Businessweek

May 1, 2023

obesity drugs could be pharma's biggest blockbuster ever

WARNING: PRICES MAY CAUSE DIZZINESS, NAUSEA;
INSURANCE COVERAGE MAY REQUIRE EXCESSIVE PLEADING 36

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◀ A sign in a Yellow Springs, Ohio, business supporting changes that Dave Chappelle has brought to the town

PHOTOGRAPH BY JOHN-DAVID RICHARDSON FOR BLOOMBERG BUSINESSWEEK

FEATURES

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■ COVER TRAIL

How the cover gets made

❶

"This week's story is about this new class of drugs that seems to actually help people lose weight."

"Oh, yeah, the one that made the Oscars possible this year?"

"These drugs aren't just for celebrities who want to fit into vintage dresses!"

"True, all the Real Housewives are using them, too."

"So funny I forgot to laugh. Seriously, though, they could have a real impact for people suffering from obesity."

"Of course, of course. So is insurance covering these drugs?"

"That's the billion-dollar question."

"But at least they're affordable out of pocket for real people right?"

"Not exactly. Some are almost $1,000 a month."

"So then they *are* just for celebrities and the wealthy?!"

"Not if the drug companies can help it."

"That's some fine print."

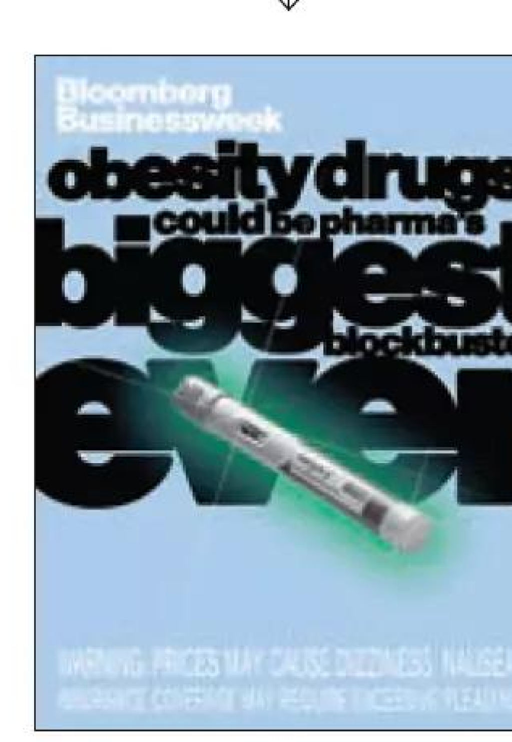

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Photo illustration by 731; photo: Wegovy

TECHNOLOGY: PHOTOGRAPH BY ALEX ATACK FOR BLOOMBERG BUSINESSWEEK

By Mark Leydorf, with Bloomberg News

● The US will bolster the nuclear deterrence it provides South Korea.

US President Joe Biden and South Korean President Yoon Suk Yeol announced the agreement on April 26 at the White House. In return, Washington secured a pledge from Seoul that it won't pursue its own atomic arsenal. The level of support will be similar to that provided to Europe under the US nuclear umbrella at the height of the Cold War. The arrangement doesn't mean US nuclear weapons would be deployed on South Korean soil, they said.

● War in Ukraine

► Chinese leader Xi Jinping spoke with Ukrainian President Volodymyr Zelenskiy for the first time since Russia invaded 14 months ago.

► Russia threatened to pull out of the UN-brokered deal to protect Ukrainian grain shipments, after accusing Kyiv of launching an attack on its Black Sea fleet with unmanned boats.

► In a rare display of opposition, a group of leading Russian lawyers on April 25 asked the nation's highest court to declare a law banning criticism of the armed forces unconstitutional, the *New York Times* reported.

● Author E. Jean Carroll arrived at court in New York on April 25 for the beginning of her civil suit against Donald Trump. Carroll claims the former president—who's the target of multiple criminal investigations as well—raped her in the 1990s.

● Tesla will drop the price of the Model Y; GM will stop producing the Bolt EV.

Tesla will charge $46,990 for its SUV—$759 below the average US price for a new car or truck. A year ago, it cost about $20,000 more than the average car. GM announced it will reconfigure its Bolt plant, in Michigan, to make battery-powered Chevrolet Silverados and GMC Sierra pickups. The Bolt was one of the cheapest battery-powered models on the market. ▷ 32

● Johnson & Johnson is seeking to raise as much as

$3.5b

by spinning off its consumer health business in what would be the biggest US IPO since 2021. Kenvue, as the company will be known, will include dozens of J&J's household names, including Listerine, Neutrogena, Nicorette and Tylenol, according to SEC filings.

● Pras Michel, a Grammy-winning rapper turned political influencer, was convicted on April 26 of conspiring to wage a back-channel lobbying campaign to end US probes of the 1MDB scandal fugitive Jho Low, get authorities to extradite a dissident Chinese billionaire and funnel Low's money into the 2012 campaign of Barack Obama. Michel, 50, who rose to fame in the 1990s with the Fugees, faces as many as 20 years in prison. His lawyer says he will appeal.

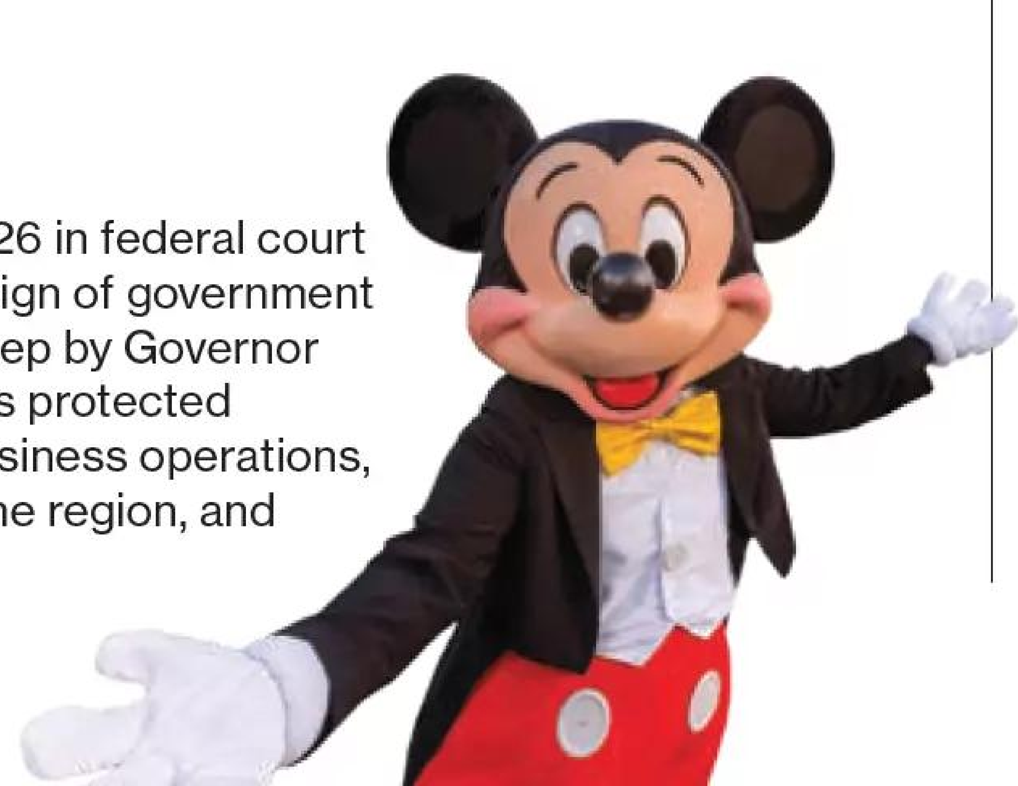
● UN Secretary-General António Guterres urged the international community to step up pressure to end fighting in Sudan, warning of regional repercussions as a tenuous cease-fire between the army and the paramilitary Rapid Support Forces is repeatedly tested. The clashes, which began on April 15, have left at least

427

dead and 3,700 injured.

● "Patently retaliatory, patently anti-business, and patently unconstitutional."

Disney sued Ron DeSantis on April 26 in federal court in Florida, saying "a targeted campaign of government retaliation—orchestrated at every step by Governor DeSantis as punishment for Disney's protected speech—now threatens Disney's business operations, jeopardizes its economic future in the region, and violates its constitutional rights."



● The antitrust watchdog of the UK vetoed Microsoft's

$69b

Activision Blizzard

takeover of Activision Blizzard, in a likely fatal blow for the mammoth gaming industry deal. The Competition and Markets Authority said on April 26 that its concerns couldn't be solved by various proposed remedies, including selling the blockbuster title *Call of Duty*. Microsoft says it will appeal the decision.

● Harry Belafonte, legendary singer, actor and civil rights activist, died on April 25 at 96.

Belafonte's *Banana Boat Song*—with its opening cry "Day-O"—propelled him to fame in the 1950s. He won a Tony and several Grammy awards and was the first Black male performer to win an Emmy. But Belafonte was even more committed to his activism. He was at Martin Luther King Jr.'s side for his "I Have a Dream" speech in 1963 and later opposed the US wars in Vietnam and Iraq. "I wasn't an artist who'd become an activist. I was an activist who'd become an artist," he said in his 2011 memoir, *My Song*.

CARROLL: STEPHANIE KEITH/BLOOMBERG. BOLT, GM, MICHEL: GRAEME SLOAN/BLOOMBERG. MICKEY: GETTY IMAGES. BELAFONTE: GETTY IMAGES

Pharma Middlemen Deserve a Share of the Blame for Drug Prices

The US spends more on prescription drugs than any other country in the world. It's easy to blame the drugmakers, but they're by no means the only ones at fault. Lowering costs to consumers will also require lawmakers to scrutinize pharmacy benefit managers, the middlemen in a bewilderingly opaque supply chain.

PBMs started in the 1960s as a "back office" for health plans to process claims. Over time, they expanded their reach—negotiating rebates from pharmaceutical companies; creating lists of drugs, known as formularies, that providers of health benefits agree to cover; and developing networks of preferred pharmacies.

Businesses that pay for their employees' health benefits often give PBMs a cut of the rebates. This encourages PBMs to favor expensive drugs for their formularies. Costs get driven up further because drugmakers offset rebates by setting higher list prices. PBMs also make money by inflating the cost of generics; discouraging pharmacies from undercutting the PBMs' negotiated prices; tweaking unfathomably complex contracts to their advantage; and steering patients to higher-priced drugs and in-house services.

Predictably, this convoluted system has given rise to still other intermediaries. Employers often hire consultants to help them pick a PBM, for instance. But more layers of middlemen, each introducing new conflicts of interest, cannot be the answer.

The system's upward pressure on negotiated prices (net of rebates) is bad enough, but it understates the harm. The uninsured, often those with the lowest incomes, are left to pay the full list price; those with co-insurance or high deductibles also face costs linked to list prices (page 36). These outcomes are grossly unfair as well as absurdly inefficient.

The problem isn't the rebate, as such: Negotiating discounts for bulk purchases is standard practice in most industries. What distinguishes drug pricing in the US from arrangements in, say, the UK or Canada is the absence of a single negotiator—a government agency—empowered to get a good deal. The consequences of this lack of power on the buyers' side are then amplified by the system's extreme opacity. Buyers don't know what others are paying. If they did, they probably wouldn't stand for it.

Congress says it wants to drive down prescription prices and has zeroed in on PBMs. Given the complexities of the industry, there's a danger of unintended consequences—but one essential step should be uncontroversial. The system needs more transparency concerning rebates and every other aspect of drugmakers' contractual arrangements. Senators Chuck Grassley, an Iowa Republican, and Maria Cantwell, a Democrat from Washington, have proposed changes of this kind. Their plan would expose and discourage the current system's anomalies, while making it easier to devise a more ambitious reform.

Some argue that greater transparency might itself raise drug costs by making it harder for PBMs to negotiate rebates. But rebates set against artificially inflated prices aren't real savings. New PBM business models are emerging that could preserve the intermediaries' value as negotiators while correcting their misaligned incentives.

Drug companies charge US customers too much for their products, and the Biden administration is rightly addressing ways to bring them in line. But the manufacturers aren't the only problem. To lower those exorbitant costs, everybody needs to take a good, hard look at the middlemen. Ⓑ

For more commentary, go to bloomberg.com/opinion

■ AGENDA

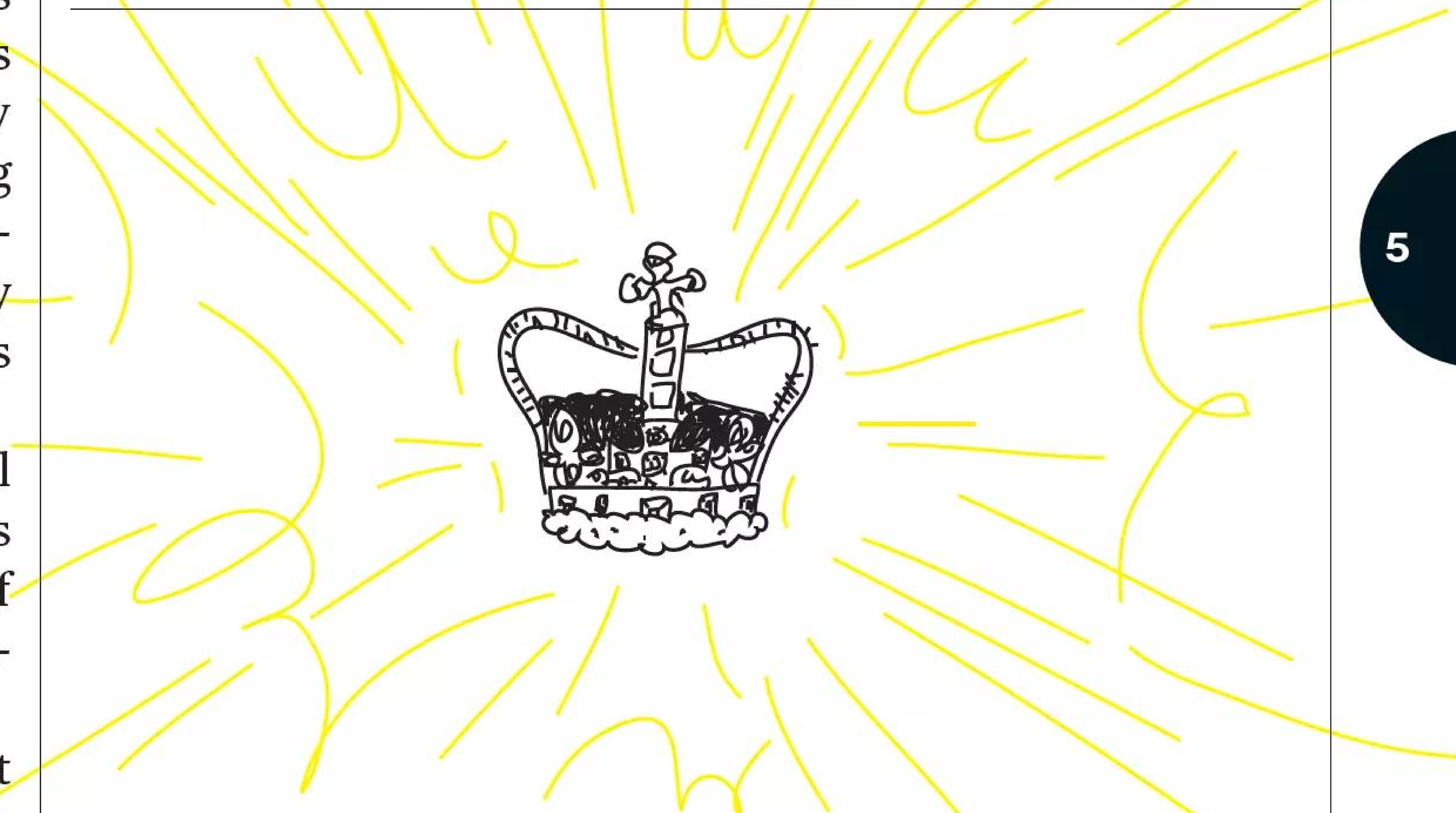


ILLUSTRATION BY 731

▶ Charlie's Big Day

The coronation of Charles III and Camilla as king and queen of the UK and the other Commonwealth realms takes place on May 6 at Westminster Abbey in London. Charles, 74, is the oldest person ever to ascend to the British throne.

▶ The Federal Reserve sets US interest rates on May 3; the European Central Bank, on May 4. Inflation is slowing in most of the world, but analysts say the end of hikes isn't quite in sight.

▶ March unemployment data for the euro zone is out on May 3; Canada and the US report their April figures on May 5. Analysts expect it to remain flat in the US but tick up in the other two.

▶ Consumer confidence readings are due from Japan on May 1, Switzerland on May 2 and Australia on May 8. Lately, consumers in all three have felt increasingly optimistic.

▶ BP, Advanced Micro Devices, Ford, Marriott, Pfizer, Starbucks and Uber report earnings on May 2; Anheuser-Busch and Shell, on May 4; Berkshire Hathaway, on May 5.

▶ On May 3, the UN marks the 30th edition of World Press Freedom Day. The Guillermo Cano World Press Freedom Prize, established in 1997 by Unesco, will be awarded.

▶ The Miami Grand Prix, the fifth round of the 2023 Formula One championship, will be held on May 7. Defending champ Max Verstappen faces a challenge from Charles Leclerc.

Learning From Europe's ESG Missteps

● Europeans don't care if ESG is "woke," just that it's not greenwashing

● By Tasneem Hanfi Brogger

ESG investing, you may have noticed, has become a political lightning rod in the US. To liberals, it's slowing global warming and fighting social injustice. To conservatives, it's spoiling the economy and the American dream. So is it saving the world or destroying it? Truth is, it's doing neither. But left to its own devices, the lucrative ESG fund industry is doing a pretty good job at destroying itself.

Bloomberg Intelligence has estimated that global ESG investment could hit $50 trillion in 2025, triple the amount in 2014. But without a common definition of what makes for good environmental, social and governance investments, fund companies have been free to slap the ESG brand on just about anything. Trusting investors often put money toward companies they might otherwise wish to avoid. Even ESG adherents sometimes have a hard time defending the label, in part because of disagreement over what it's supposed to measure.

Companies that score ESG investments seem equally confused. By the end of April, 31,000 funds were set to have their ESG ratings downgraded by a unit of MSCI Inc., which created its first ESG-like index in 1990 and is today one of the largest firms scoring funds and companies on ESG. (Bloomberg LP, the

parent of *Bloomberg Businessweek*, also provides ESG scores.) The changes mean that only 0.2% of MSCI-graded funds will have the highest rating in the future, compared with about 20% now, raising questions about the value of such scores. MSCI says the downgrades were spurred by client unease over the perceived "upward drift" in scores and are unrelated to regulations in Europe or elsewhere.

An even more fundamental problem for ESG investors is that MSCI ranks companies on their ability to manage risks from ESG factors, while other gatekeepers such as S&P Global Inc. consider the effect companies have on the ecosystem in which they operate. The result can be radically different grades for a single company. MSCI says it also offers tools for those seeking to invest in companies or funds that match their values.

Amid all this confusion, it's worth looking at European regulators' and lawmakers' efforts to help investors allocate their capital in ways that ESG was intended. It's not a pretty picture. Even though ESG in Europe doesn't create the political clashes it does in the US, Europe's ESG fund market has been roiled by continual revisions to incomplete rules, leaving clients wondering how sustainably their savings are being allocated.

In 2021 the European Union started enforcing the Sustainable Finance Disclosure Regulation, or SFDR, to help investors figure out how much ESG bang they were getting for their buck by sorting funds into three classes. Article 9 is the highest, for funds that make ESG their "objective." In practice, that means holding only sustainable investments, with some allowance for hedging and liquidity. Article 8 requires that funds "promote" ESG, a far vaguer mandate. And Article 6 is for everything else, but it still requires that fund managers consider whether ESG risks are relevant.

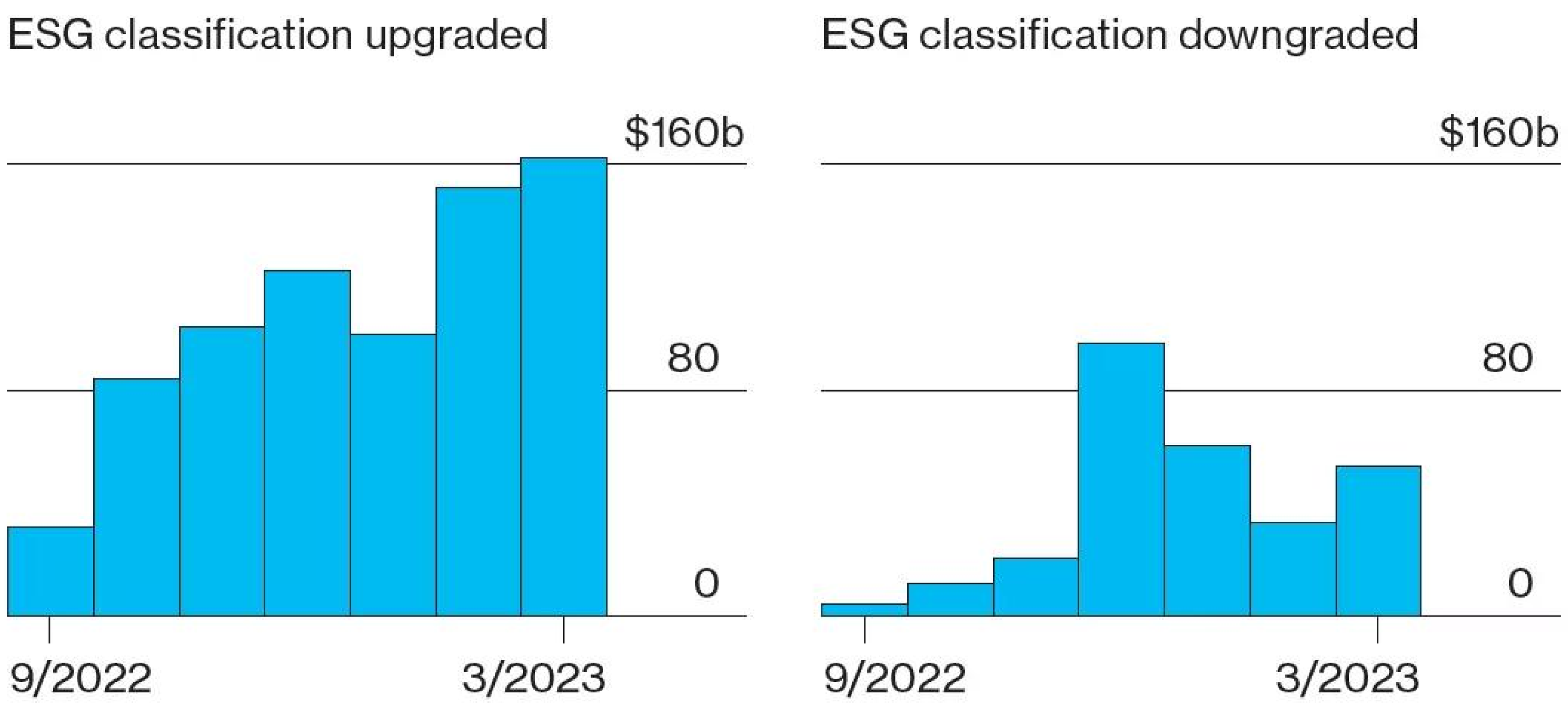
The rules resulted in asset management companies reclassifying hundreds of funds late last year to meet a Jan. 1 deadline requiring them to prove any ESG claims. Market researcher Morningstar Inc. estimates that the Article 9 designation was stripped from about €175 billion ($190 billion) worth of funds in the final months of 2022.

The turmoil continues. In mid-April, European authorities published a series of clarifications and proposals that have much of the region's investment management industry heading back to the drawing board. Some asset managers even question whether they were wrong to downgrade their Article 9 funds in the first place.

Crucially, the EU failed from the get-go to provide a clear definition of a sustainable investment, which allowed fund managers to come up with wildly different definitions when designing portfolios. The European Commission, the EU's executive arm and a principal architect of SFDR, has now attempted to clarify how it wants investors to treat the concept of "sustainable investment." The upshot appears to be that asset managers will have considerable leeway, and the onus will be on investors to figure out what they're getting with this guideline: If a company gets only a portion of its revenue from a sustainable activity, but otherwise doesn't do any significant environmental or social harm,

A Moving Target for European Investors

Funds' assets that have changed classifications



UPGRADES AND DOWNGRADES OF SFDR-REGISTERED FUNDS BASED ON DATA COLLECTED AS OF MID-APRIL. RECLASSIFICATION DATES MAY VARY DEPENDING ON FUND HOUSE DISCLOSURE AND DATA COLLECTION. TOTAL ASSETS AS OF LATEST DISCLOSURES. DATA: BLOOMBERG INTELLIGENCE, BI SFDR DATASET AND BAROMETER

investors can consider that an overall sustainable investment.

"I think someone on the Commission side has gotten worried that the whole edifice of SFDR might not get the respect that it deserves," says Eric Pedersen, head of responsible investments at Nordea Asset Management. "And so they're trying to fix some of those things."

The list of things to fix remains long. Article 9 is supposed to be reserved for funds that put all their money into sustainable investments, yet Morningstar said in late January that only about 6% of them are anywhere close to meeting that standard.

A November study by Clarity AI, a sustainability technology platform, found that almost 1 in 5 Article 9 funds have more than 10% of their investments in companies that violate the United Nations Global Compact principles or the Organization for Economic Cooperation and Development's guidelines on the environment and human rights. Another problem is that numerous funds were downgraded to Article 8's vague "must promote ESG" classification. Regulators are trying to figure out how to come up with a more meaningful framework.

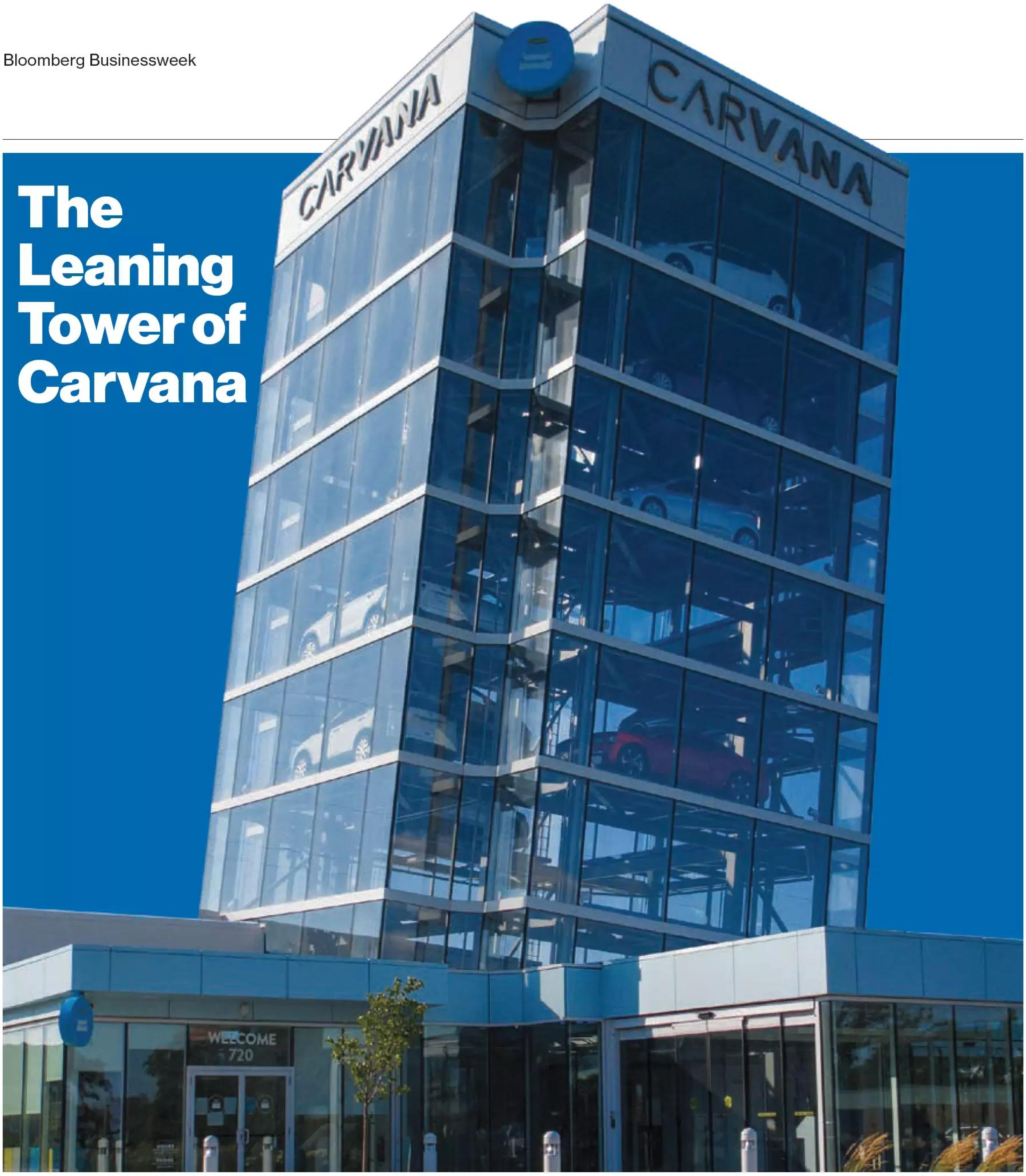
Late last year, the European Securities and Markets Authority, the region's top markets regulator, added to the chaos. It said the EU should apply minimum thresholds to any funds that market themselves as ESG or sustainable. At least 80% of a fund sold under an ESG label must be verifiably ESG. If it also calls itself sustainable, at least half of the 80% must be verifiably sustainable. The idea has elicited almost universal condemnation from market participants.

The regulator is plowing through the feedback but has said it still aims to move ahead with some version of its proposal this year. If the plan ends up being enforced in its current form, Morningstar figures that only 27% of the more than €4 trillion in fund assets it estimates are registered as Article 8 could be marketed as sustainable.

None of this means ESG is doomed to fail. Pedersen at Nordea says it's wrong to expect anything other than a drawn-out process when reimagining the laws of capital allocation. Attention to detail—in other words, data and transparency—will ultimately make the difference in whether investors understand what an ESG label really means. The US should take note. Ⓑ —*With Frances Schwartzkopff*

ILLUSTRATION BY BAPTISTE VIROT

The Leaning Tower of Carvana



● A proposal to reduce the retailer's $8 billion in debt would cut the value of creditors' holdings by almost 25%

Carvana Co. was custom-built for the low-interest, easy-credit era. It raised billions of dollars on promises of revolutionizing the used-car business via a streamlined online sales model, then it spent the money on hundreds of thousands of preowned autos and luring buyers with cheap loans. A semiconductor shortage that crippled new-car manufacturers lifted sales, and revenue jumped eightfold over six years. The company built dozens of auto-filled glass towers and repair centers across the US, where customers slide a pancake-size coin into a slot to get their vehicle, as if from a vending machine. Shares that opened at $15 in 2017 soared to $370 by August 2021.

But tighter monetary policy and a rebound in auto production have shifted Carvana into reverse. The company added $1 billion in used vehicles in the months before prices peaked in the spring of 2022. Then, as higher interest rates increased the cost of loans, potential customers started to reconsider whether they really needed new wheels. Sales fell 23% in the fourth quarter, fueling a $2.9 billion loss on $10.3 billion in revenue last year. As of December the company had $8 billion in debt, 64,000 cars on its lots and just over $400 million in cash (as well as a $1.4 billion line of credit). And those shares? They're now trading at less than $10. "Will they ever make money?" says Doug Arthur, an analyst at Huber Research Partners LLC. "I think you have to question that." ▶

PHOTO ILLUSTRATION BY 731; PHOTOS: ALAMY (1)

Edited by James E. Ellis and David Rocks

◀ Led by Chief Executive Officer Ernest Garcia III and his father, Ernie Garcia II, the company has proposed that creditors trade $1.3 billion in debt for $1 billion in notes secured with various assets while shareholders like the Garcias—they own 8% of common stock and 88% of voting shares—wouldn't suffer a loss. "This is a coercive exchange of wealth from debt- to equity holders," says Bloomberg Intelligence analyst Joel Levington.

Not surprisingly, most creditors rejected the offer, according to people familiar with the matter, who asked not to be identified discussing private conversations. Bondholders might extend the timeline for repayment in exchange for the collateral, but they're unwilling to accept the lower value the family is proposing, the people say. A $168 million interest payment on bonds due in May threatens to trigger a default, which could spur the family to accept tougher terms. Carvana declined to comment on the negotiations.

Garcia III said in February that he can cut expenses by $1 billion this year and improve cash flow, almost doubling gross profit per vehicle sold, to more than $4,000. But after factoring in the cost of running its outlets, taxes, interest and salaries for more than 16,000 staffers, the company last year realized a net loss of more than $7,000 per car it sold. Bloomberg Intelligence predicts that even if creditors were to take the deal, it wouldn't reduce debt enough to turn the company around. "What you get on other side is a shell of a company with too much debt," Levington says.

After ending 2021 with more than $5 billion in debt, Carvana last year borrowed an additional $3.3 billion. Part of that money went to the $2 billion purchase of auto auction house Adesa, which the company said would allow it to buy and recondition more vehicles: Adesa had 56 locations around the US that could process 2 million cars a year. Carvana sealed the deal in May 2022. Over the next seven months, used-car prices tumbled 15%.

To bring its debt under control, Carvana must rein in overhead costs, equal to 22% of sales, versus 9% for rival CarMax Inc., according to Bloomberg Intelligence. Part of Carvana's high costs can be attributed to its pricey vending machine storefronts and Adesa locations that have given the company far more capacity than it needs to refurbish cars as it downshifts to a slower pace of sales. Add to that the opening in 2017 of what Carvana calls HQ1, a long, low building near the Phoenix airport with a lounge featuring a poker room and a bar for employees.

According to a lawsuit filed by two big pension funds, the Garcias have a history of extracting wealth from Carvana through stock sales and related-party deals. Garcia II owns another used-car business, DriveTime Automotive Group, which leases office space to Carvana, reconditions vehicles for the company and sells warranty products such as prepaid maintenance plans. A DriveTime affiliate called Bridgecrest Acceptance Corp. processes loans originated by Carvana. And another Garcia-owned outfit, Verde, leases private aircraft to Carvana executives. All in, the lawsuit and US Securities and Exchange Commission filings say, Carvana paid the elder Garcia's companies $406 million in 2021 and 2022.

But the real money, according to the lawsuit, was in stock sales. As the price peaked in 2021, the elder Garcia dumped some 14 million shares, netting $3.7 billion, and other members of management sold almost $300 million worth, according to company filings and Bloomberg data. The plaintiffs allege that Carvana bought cars from DriveTime and then quickly sold them back to inflate sales numbers and prop up the share price. Carvana twice modified Garcia II's 10B5-1 plan, which provides a schedule for stock transactions by insiders, to accelerate sales, the complaint states. That's not illegal, but the lawsuit says the company is set up to benefit the family and the maneuver was intended to help the Garcias get rid of shares before the price crashed. Carvana calls the lawsuit "meritless" and has moved for a dismissal, arguing the plaintiffs haven't proven any fraud.

Investors shouldn't be surprised that the Garcias run the company with their own interests in mind. Carvana's 2022 annual report explicitly stated that the family's other businesses may compete with Carvana, and because the Garcias control the bulk of voting shares, they can dictate strategy and name all directors. Garcia III is chairman of the board, and he and two of the other five directors have held positions at DriveTime. "The interests of the Garcia Parties may not in all cases be aligned with our stockholders' interests," the report said.

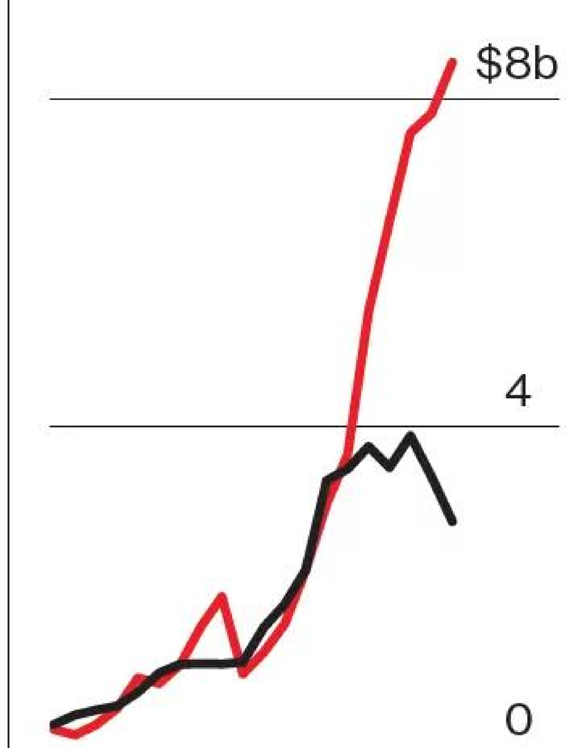
Daniel Taylor, director of the Wharton Forensic Analytics Lab at the University of Pennsylvania, says it's little surprise that Carvana's fortunes shifted so dramatically. Given the cyclical nature of the business, a downturn was inevitable at some point, and the stock sales by insiders pointed to a lack of confidence on the part of management. "Those all are giant red flags," Taylor says. "The governance structure looks like it was set up to benefit the family." —*David Welch, Eliza Ronalds-Hannon and Amanda Albright*

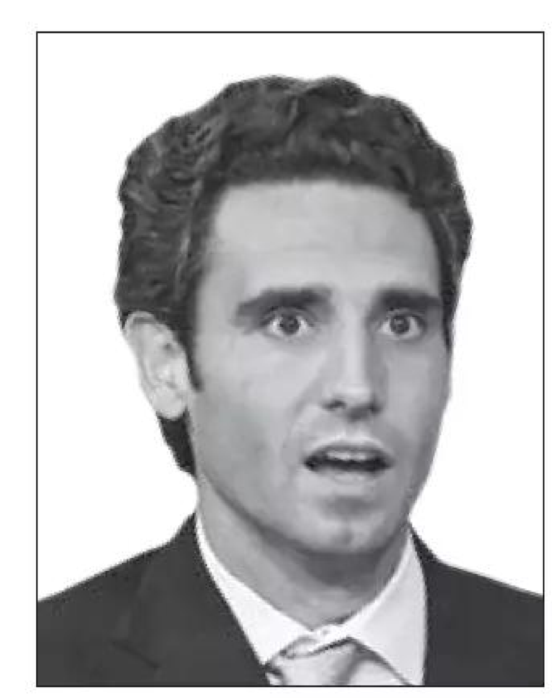
THE BOTTOM LINE A lawsuit alleges that the elder Garcia's companies got $406 million from Carvana, and that he netted $3.7 billion by selling 14 million shares before the price plummeted.

▼ Carvana's financials

Revenue

Net debt





● Garcia III

10

TRUCK: GETTY IMAGES. GARCIA II: BLOOMBERG. ILLUSTRATION BY AXEL PFAENDER. DATA: COMPILED BY BLOOMBERG

Walmart Is Using AI to Negotiate Contracts

● Assigning chatbots to haggle price and delivery terms with vendors is faster than using humans

As ChatGPT dazzles the general public with fanciful uses of artificial intelligence, such as writing Hollywood scripts or opining on fantasy baseball and art theory, Walmart Inc. is leaning on AI for a more pragmatic purpose: bargaining with suppliers.

The retail giant uses a chatbot developed by Mountain View, California-based Pactum AI Inc., whose software helps large companies automate vendor negotiations. Walmart tells the software its budgets and needs. Then the AI, rather than a buying team, communicates with human sellers to close each deal. "We set the requirements and then, at the end, it tells us the outcome," says Darren Carithers, Walmart's senior vice president for international operations.

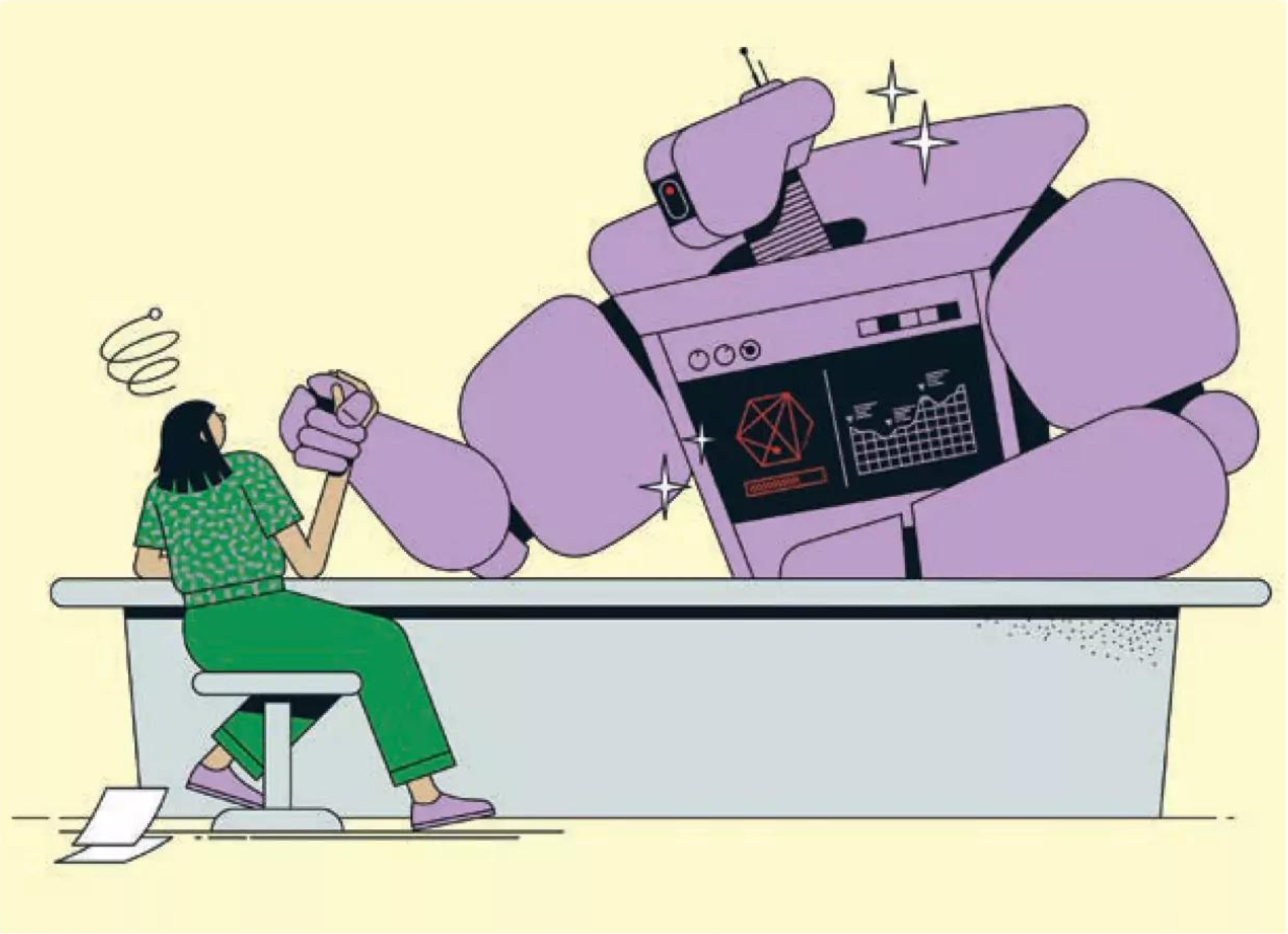
Carithers says Pactum's software—which Walmart so far is using only for equipment such as shopping carts, rather than for goods sold in its stores—has cut the negotiating time for each supplier deal to days, down from weeks or months when handled solely by the chain's flesh-and-blood staffers.

The AI system has shown positive results, he says. Walmart said it's successfully reached deals with about 68% of suppliers approached for the Pactum project, with an average savings of 3% on contracts handled via computer since introducing the program in early 2021.

Walmart was Pactum's first customer and one of the few major retailers in the US to adopt AI in its vendor negotiations at all. Like Walmart, Amazon.com Inc. has dedicated account managers for category-leading brands like Nestlé SA and Procter & Gamble Co., but it automates other types of vendor discussions, according to Martin Heubel, a former Amazon executive who now advises brands selling goods on the site. Rival Target Corp. says it doesn't use AI for supplier negotiations.

"The huge potential is that any kind of company can soon use AI for a problem that normally requires an entire procurement team to handle," says Tim Baarslag, a senior researcher at CWI, the National Research Institute for Mathematics and Computer Science in the Netherlands. Negotiating used to be a human-only skill, he says, but now AI is just as capable.

Pactum's software is just one of several AI tools the world's largest retailer has adopted in recent years as it seeks ways to save its corporate team and customers time and money. Walmart announced a partnership with Microsoft Corp.



in 2018 to work on artificial intelligence and other strategic tech and has been using AI developed by Microsoft-backed OpenAI to offer conversational text-to-shop tools, which the retailer touted in December. A consumer-facing chatbot, which can provide information such as the status of orders or returns, is now used by more than 50 million customers, Chief Executive Officer Doug McMillon said in a letter to shareholders in April.

Walmart—which has more than 100,000 total suppliers—started using Pactum with a pilot for its Canadian unit. The project then expanded to the US, Chile and South Africa. Pactum's other clients include shipping company AP Moller-Maersk A/S and electrical products vendor Wesco International Inc., among others, according to its website. ▶

"The huge potential is that any kind of company can soon use AI for a problem that normally requires an entire procurement team"

◀ Artificial intelligence isn't a threat to Walmart's human negotiators, at least not yet. Instead the company is using the tool to squeeze savings from contracts that might not be big enough to justify taking up much–if any–of a procurement manager's time. Pactum's software can haggle over a wide range of sticking points, including discounts, payment terms and prices for individual products.

When a vendor says it wants to charge more for an item, Pactum's system compares the request with historical trends, what competitors are estimated to pay and even fluctuations in key commodities that go into making the item, among other factors. It then tells Walmart the highest price it thinks its buyers should accept, a figure that a human procurement officer can modify if needed.

Then the real negotiation starts. Pactum's chatbot communicates with a flesh-and-blood vendor on the other side, displaying a series of arguments and proposals the supplier can accept or reject.

"There's so much data, so much back and forth, and so many variables that can be tweaked," says Pactum CEO Martin Rand. "The AI bot with a human on the other side will find a better combination than two people can over email or on the phone."

Suppliers cede profit in at least some of the negotiations, but Pactum says they can get concessions such as better payment terms and longer contracts in return.

Three out of four suppliers that have tested the program told Walmart they preferred negotiating with the AI over a human, the retailer says, though a small percentage said they would've liked to negotiate with a person. "Some really like it and are like, 'This is the best way to do it,' " says Carithers, the Walmart executive. "But I would relate that to people using self-checkout in stores. Some customers love it, but guess what: Some customers want to go to a manned checkout and see a person."

Although AI software is now being used to help overburdened procurement staffs, at some point humans may be all but taken out of the equation. Pactum is researching how to conduct bot-to-bot negotiations, Rand says. But there are obstacles to making that happen anytime soon. Machines still have trouble making assessments with limited information, and they can't draw in external details like vendor relationships. So for now, Walmart's arm-wrestling matches over small contract terms will be man versus machine, however lopsided that will be. *—Daniela Sirtori-Cortina and Brendan Case, with Spencer Soper*

THE BOTTOM LINE Using an AI-fueled chatbot to do the hardball negotiating, Walmart has cut the time to complete some vendor deals to just a few days, down from weeks or months previously.

Shale Drillers Face An $8 Billion Shock

● US gas prices have tumbled almost 80% since August, and some companies are expected to shut wells as their finances tighten

Skyrocketing energy prices turned US natural gas drillers into cash machines that rewarded shareholders with fat returns and stock buybacks over the past two years. But the heyday appears to be over.

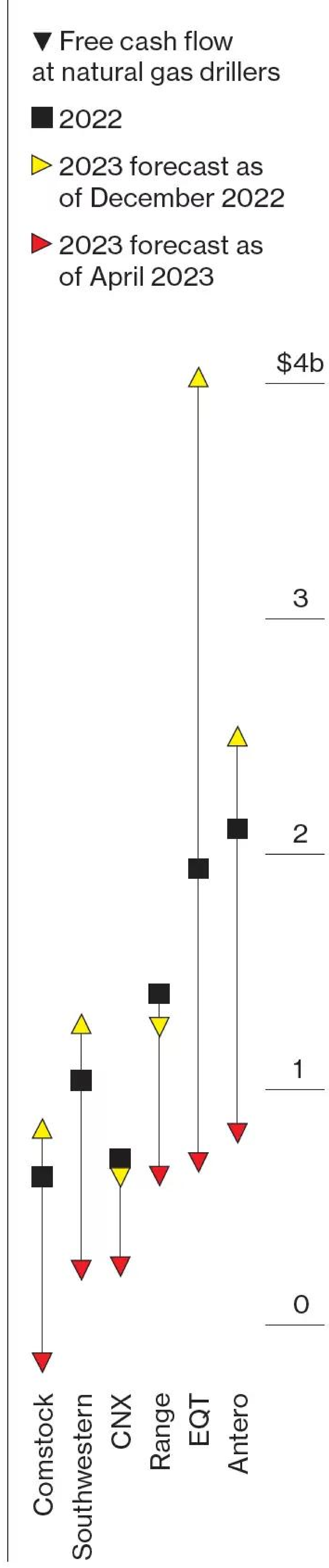
A US supply glut that no one saw coming triggered a collapse in the prices of the power plant and furnace fuel, prompting analysts to slash free cash flow estimates for the sector. For a group of six gas-focused shale drillers that includes top producer EQT Corp., that means about $8 billion that was expected to be available for dividends and share buybacks is now off the table. In just four months, the collective 2023 cash flow outlook for the group shriveled by 75%.

This reversal of fortunes underscores the dramatic drop in domestic gas that as recently as August was at a 14-year high, commanding more than $10 per million British thermal units. In April the fuel languished around the $2.17 mark, a price so low that some explorers are canceling drilling projects and recalling rigs from the field.

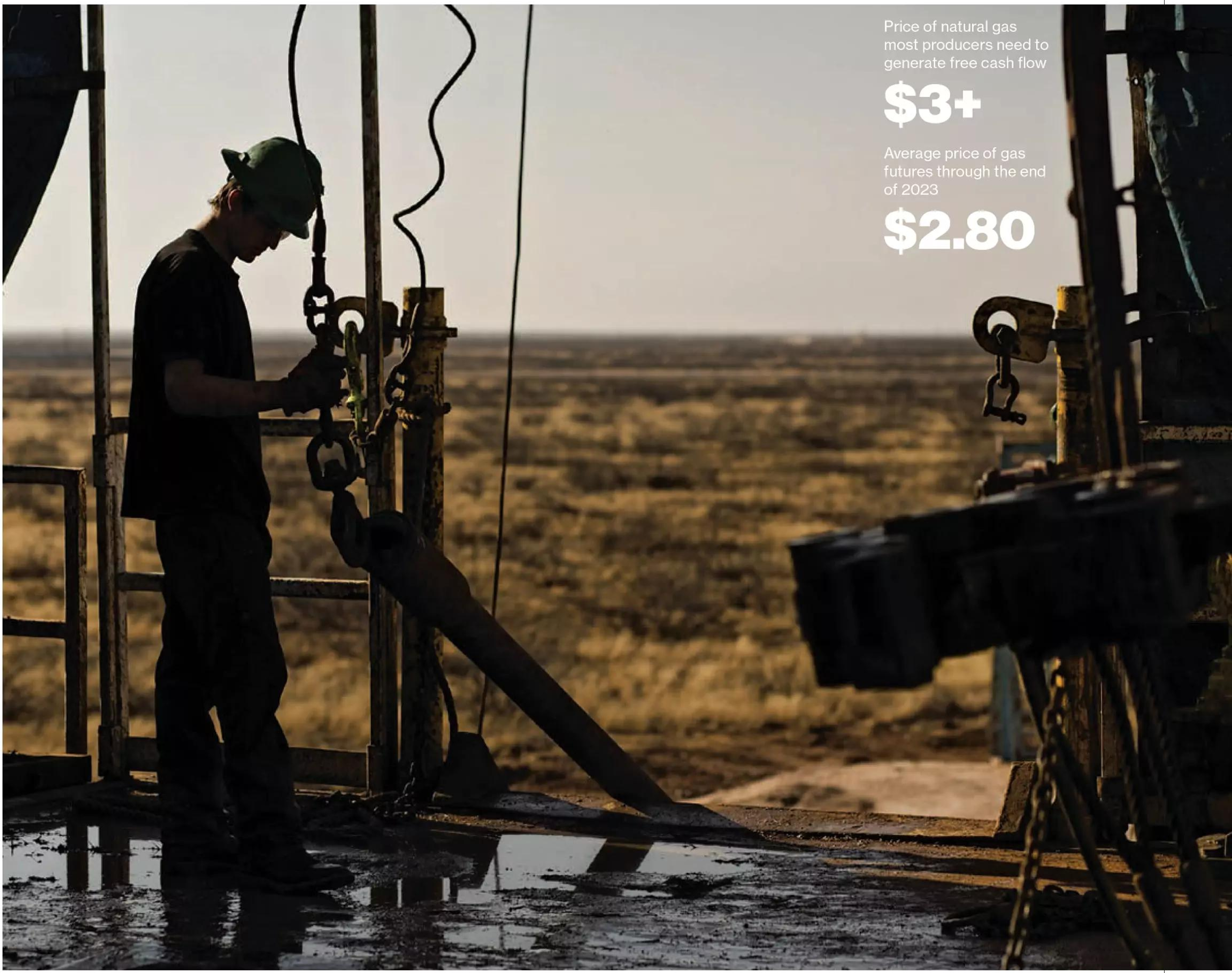
The glut developed after a key US gas export facility was shut by a fire and an abnormally mild winter slashed heating demand. Investors got their first glimpse of how deep the price slump has cut when US drillers began announcing first-quarter results in late April.

Gas futures for delivery through the end of this year are averaging around $2.80 on the New York Mercantile Exchange, below the $3-plus that most producers need to generate "reasonable" free cash flow, according to Rob Thummel, who helps manage about $8 billion in energy-related assets at Tortoise Capital. "That will limit the amount of income to buy back stock and pay the dividends that some of these companies have stated," says Thummel. Some companies may curb capital spending to protect investor payouts, he adds.

Depressed gas prices are pushing drillers to curtail production growth in the interests of cash preservation. Comstock Resources Inc. and Southwestern Energy Co. already have signaled a slowdown in work in Louisiana's Haynesville Shale region.



SHALE: BRITTANY SOWACKE/BLOOMBERG. DATA: COMPANY REPORTS, BLOOMBERG SURVEY OF ANALYSTS



▲ Waiting to connect a drill bit at an Endeavor Energy Resources rig near Midland, Texas

"What's going to suffer the most is the number of drilling rigs," says Angie Gildea, who leads KPMG LLP's US energy, natural resources and chemicals team. Management teams "will take lower production growth over having to reduce dividends to shareholders," she says.

The situation is so dire that Citigroup Inc. analysts see some companies shutting wells. That usually happens only in natural disasters. "We expect further reductions across both natural gas rigs and frac fleets in the Haynesville, while throttling and shut-ins are likely to be needed across all basins by the summer," Citigroup analysts led by Paul Diamond wrote in a note to clients, referring to possible slowdowns or halts in some fracking operations.

To be sure, most US gas producers are expected to generate free cash flow this year. What's more, a rebound is seen for 2024 as export demand strengthens, buoying prices. "I don't think we can keep below $3 natural gas for very long," Thummel says. "And that just means a lot of free cash flow for these companies going forward."

But at least for the rest of 2023, drillers face challenges that include a tougher borrowing environment. A recent survey conducted by law firm Haynes & Boone LLP shows most industry participants expect bank credit lines to energy explorers to shrink in coming months as the value of their oil and gas reserves erodes. And companies will continue to struggle with cost inflation and labor shortages. "When you can't get crews, when your costs are 20%, 30% higher than they have been," says KPMG's Gildea, "it makes it a lot more difficult to manage through a price downturn." *—Gerson Freitas Jr.*

THE BOTTOM LINE Over the past two years, shale drillers kept investors happy through rich dividends and share buybacks. But the recent plunge in gas prices will pinch their cash generation.

When Fishing Boats Cut the Cord

Equipment regularly damages subsea cables, but fishers say they're the ones suffering

Edited by
Joshua Brustein

● A remote-controlled vehicle used for repairs

On the evening of Oct. 14, the managing director of Shefa, a Faroese Telecom subsidiary, received a call from one of his technicians: There was a fault on the cable connecting Shetland, an archipelago 100 miles off the coast of Scotland, to the Faroes. Days later, just after midnight on Oct. 20, Pall Hojgaard Vesturbu got a second call: Another cable between Shetland and the UK mainland was damaged.

Together, the faults severely disrupted telephone and internet communication on the islands and stopped shops from taking credit card payments for a day.

It was less than a month after the Nord Stream pipeline explosions, and Western governments had identified subsea cables as a potential target for state-sponsored sabotage. But Vesturbu had another culprit in mind: the fishing industry. "It's frustrating," he says, noting that fishing vessels have caused almost all the ruptures to his company's cables. "The locations of our cables are sent to boats' navigating equipment, so it should be an automatic process to avoid sailing across the cables. Most of the sailors pay attention to the cables."

The physical growth of the internet has set tech giants such as Google, Meta and Microsoft, which are responsible for a growing proportion of the subsea cables that carry signals around the world, on a collision course with a much older industry. About 60% of disruptions are caused by equipment used to catch cod, sole, squid and other bottom-dwelling species, or by anchors dragged across the ocean floor, according to a 2021 report by the International Cable Protection Committee. (An additional 0.1% are caused by fish biting the cables.) The cost of repairs for a single incident generally ranges from $250,000 to $3 million.

The companies responsible for the cables say they provide free maps of their networks, which should help fishing and shipping vessels to steer clear. But fishers complain that the rapidly expanding infrastructure of the seas—cables and oil pipelines and offshore wind installations—is taking up precious ocean space and threatening their jobs. "Fishermen just want to fish, but we're increasingly being told to avoid all these cables," says Patrick Murphy, chief executive officer of the Irish South & West Fish Producers Organisation. "Massive companies are just swatting us out the way."

Subsea cables experience faults, mostly from accidental damage, about 200 times a year. Most of the time, there's little to no disruption to internet service, because cable operators have deals that allow them to shift traffic to an alternative route in the spiderweb of about 870,000 miles (1.4 million kilometers) of active submarine cables that span the globe. Causing a severe disruption in the UK would require the simultaneous severance of 19 cables. Less-well-connected places, particularly island communities like Shetland, are far more vulnerable.

In 2008 about 75 million people were cut off from the internet in the Middle East and India after a ship's anchor took out a cable while trying to moor in bad weather off the coast of Egypt. In 2016 a ship mistakenly dragged its anchor across the seabed in the English Channel and cut through the three main internet cables connecting the islands of Guernsey and Jersey to the mainland.

Fixing a broken cable entails summoning a repair ship—usually one in a fleet shared by several companies as part of a maintenance agreement—to sail to the approximate location, hunt for the broken cable with unmanned underwater vehicles, bring it to the surface, splice in a new section and return it to the ocean bed. The cost varies based on how long it takes to reach the damaged section, how deep the cable is and how rough the seas are. In the process, the operator of the cable also investigates the cause, with an eye to whom it might sue.

▲ Workers demonstrate the process of bringing cables to the surface for repair

European boats longer than 49 feet (15 meters) are legally required to transmit their location at all times, but some skippers turn off their tracking equipment, known as the automatic identification system (AIS), to avoid tipping off others about lucrative fishing grounds or, in some cases, to mask illegal activity. Vesturbu's team at Shefa says it's identified one of the boats responsible for October's incident through its AIS. It's in contact with the fishing company that owns the boat and is looking to recoup hundreds of thousands of dollars in repair costs. Shefa has yet to identify the other boat, which wasn't emitting an AIS signal, but it's cross-referencing other vessel tracking data with ▶

PHOTOGRAPHS BY ALEX ATACK FOR BLOOMBERG BUSINESSWEEK

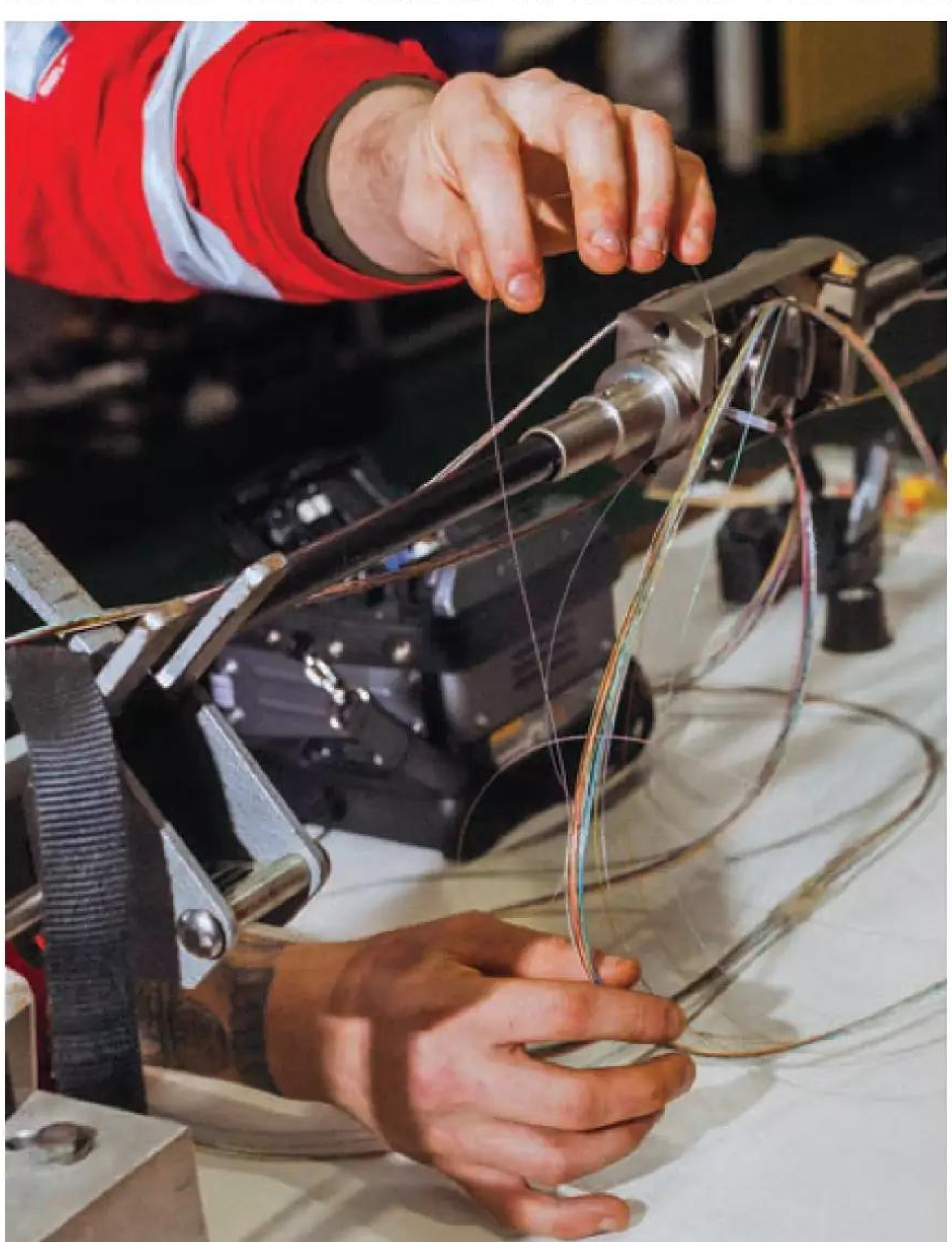
◀ satellite imagery, according to Vesturbu.

The subsea cable industry sees its responsibility as limited to providing information about the location of cables, while the fishing industry wants to be consulted before cables are installed. "Subsea cables have been around since 1884, and the cable industry does everything we can to give information to the fishing industry about where we are," says Peter Jamieson, vice chair of the European Subsea Cables Association. "They can fish up to a cable without having to fish over the cable."

Elaine Whyte, who represents the fishing industry in Scotland, says cable operators should do more to ensure they're avoiding important fishing areas. As it stands, she says she and her colleagues feel outmatched: "We are not on equal footing with these companies." She and others would like to be properly consulted during the route-planning phase to ensure that cables are either buried deep under the seabed or diverted around important fishing areas.

One solution would be to lay cables near one another in dedicated channels so boats don't have to navigate through a maze of fiber optics. But having all the cables in one place creates a greater risk of them all being taken out in one go.

For now, companies relying on the cables watch them vigilantly. Brian Quigley, the senior director of Google's global network infrastructure, monitors the company's undersea properties on a huge map for hiccups in its internet traffic. He also tracks the locations of available vessels in



◀ Repairing fiber-optic cable

case repairs are needed. Google has tried using algorithms to lay cables that avoid fishing paths and radioing boats that get too close to its equipment, without much luck. "There's very little we can do about it," Quigley concedes. Google has opted to invest in heavy armor for cables and plenty of backup routes.

In Oregon, the two industries reached a détente after Scott McMullen, a fisherman in the northern part of the state, received a notice in the mid-1990s about the North Pacific Cable, a new fiber-optic network line. The letter informed McMullen that he had to stay out of an 80-square-mile patch of sea lest he be "fined, imprisoned or electrocuted" if he damaged the cable being installed. The tiny pink shrimp he caught for a living didn't get the memo, so he often followed them over the cable. "We didn't like it," McMullen recalls. "But when you're faced with making a living, you go for the shrimp."

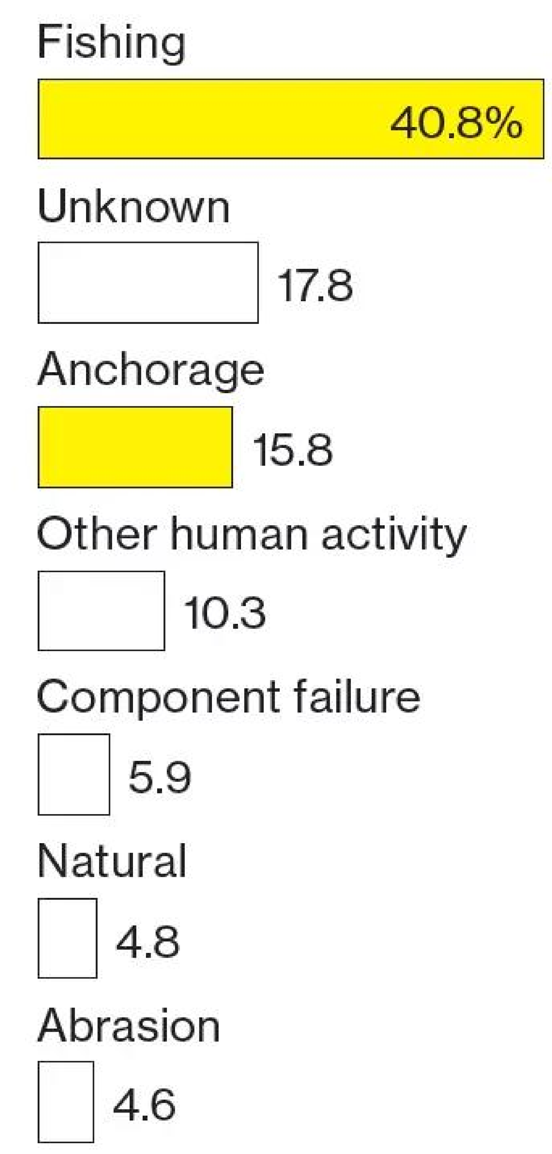
Uninterested in being jailed or shocked, McMullen connected with the cable operator, which brokered a deal: If an anchor or fishing gear got tangled near a cable, the vessel abandons the fishing trip, cable operators pay into a "sacrificed gear fund" for the affected boats, and all parties agree not to sue. In 25 years, McMullen says his group, the Oregon Fishermen's Cable Committee, had only nine cases where equipment got snagged in the seabed. None of them damaged cables.

Given the importance of internet connectivity, there's been speculation that fishing accidents could provide useful cover for deliberate attempts to sabotage. Vesturbu isn't convinced, saying that most stretches of cable are carefully buried with only some sections exposed, and it would require significant sophistication to strategically cut off internet somewhere by damaging exactly the right stretch of cable.

There was one curious case in January 2022, when a cable between Norway and Svalbard, an Arctic archipelago, was severed. Journalists at NRK, the Norwegian broadcasting company, tracked AIS data to show that a Russian fishing trawler had passed over the cable 20 times around the time it was damaged. Derek Bullock, a telecommunications consultant, thinks there are reasonable scenarios in which someone might carry out such an operation. "It's not as James Bond as you think. You don't need to use specialized equipment," he says. "All you need is a vessel, and you just drag an anchor, and the cable is gone." *—Olivia Solon and Mark Bergen*

THE BOTTOM LINE Companies that operate subsea cables say they tell fishing boats which areas to avoid, but fishers want more input into where the cables are laid in the first place.

▼ Causes of undersea cable faults



AI's Data Spigot Gets a New Knob

● OpenAI gives users control over what it does with the queries they type into its chatbot

● Murati

Millions of people ask ChatGPT for help with everything from meal planning to poetry composition. But not everyone wants their typed prompts to be used for training the artificial intelligence models underlying the chatbot.

OpenAI recently acknowledged that consumer enthusiasm for its powerful chatbot doesn't necessarily mean enthusiasm for sharing data that may be used to improve the startup's AI: The company on April 25 began letting people withhold their ChatGPT conversations from use in training the artificial intelligence company's models.

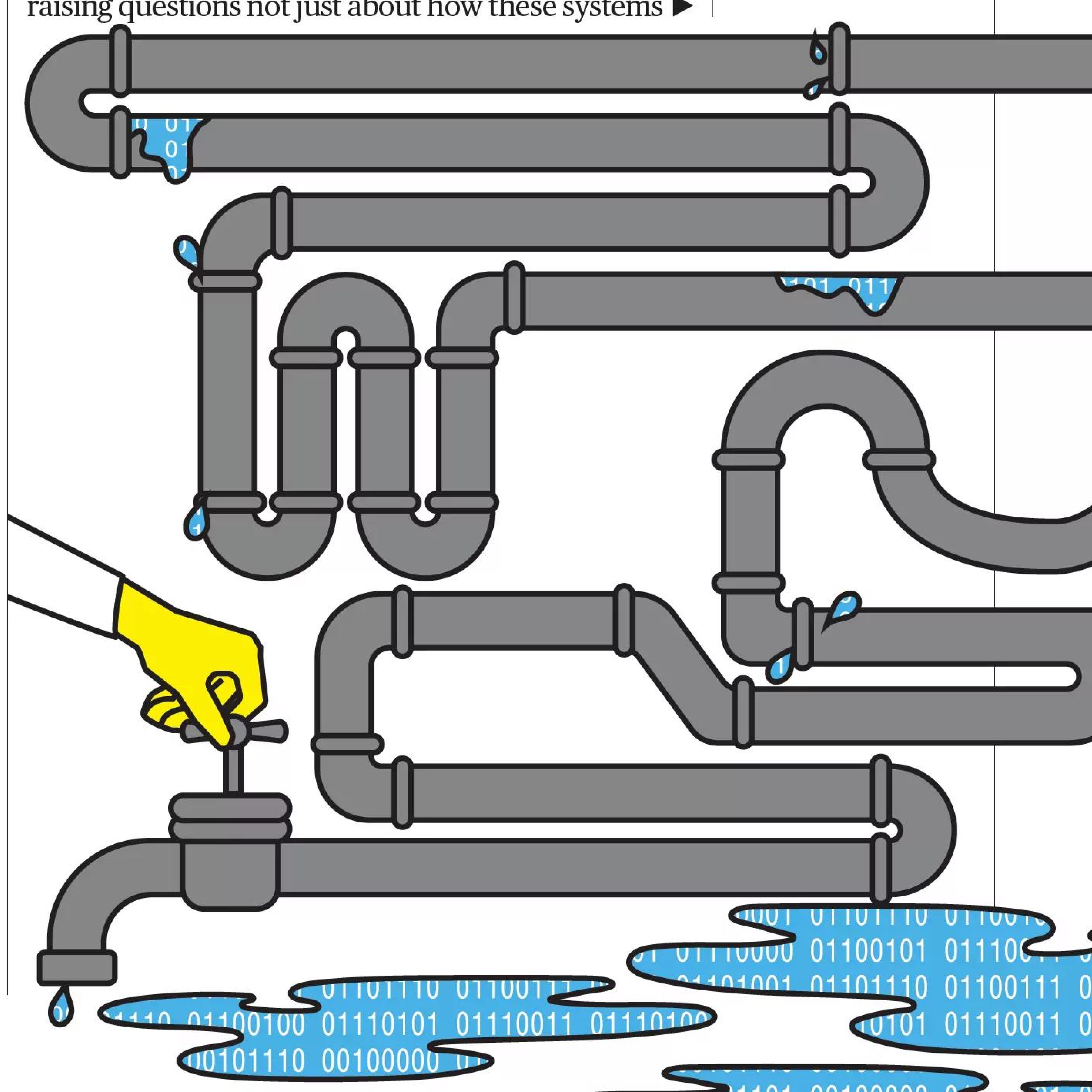
ChatGPT users can turn off their chat histories by clicking a toggle switch in their account settings. This prevents conversations from being saved in ChatGPT's history sidebar (on the left side of the web page), and OpenAI won't review or analyze that data for training as it typically would.

The feature offers a privacy safeguard for people who may be sharing sensitive information with the popular AI chatbot. During a demo of the feature, the company used the example of planning a surprise birthday party. But it's also relevant for users researching medical conditions, or dissecting fights with a family member.

For the company, it's important that people feel comfortable using a tech product that's both novel and potentially unsettling. "We want to move more in this direction where people who are using our products can decide how their data is being used—if it's being used for training or not," says OpenAI Chief Technology Officer Mira Murati. The company also announced a new ChatGPT subscription service for professionals and businesses; the default setting for that service will be not to use data from user queries to train its models, the same policy already in place for businesses using OpenAI's ChatGPT tool in their own products. It plans to make the service available within several months.

OpenAI's technology requires large amounts of human-generated text, which it studies to produce content that can convincingly replicate that communication. In addition to queries typed directly into its software, OpenAI uses vast troves of online data to train its models, though it's tight-lipped about the specifics. As the value of AI becomes clear, some websites with significant quantities of content created by humans are beginning to demand a piece of the action. The social network Reddit and the programming website Stack Overflow have both recently said they'd start charging companies to use their data to train AI models.

In the months since ChatGPT was launched publicly, millions of people have experimented with it and other bots (such as Bard, created by Alphabet Inc.'s Google). This new wave of AI chatbots is already being harnessed for everything from planning vacations to serving as an impromptu therapist, raising questions not just about how these systems ▶



◀ can be used but also how the companies process the prompts people type into them. OpenAI says its software filters out personally identifiable information that comes in from users.

The feature, which brings to mind the "incognito" mode offered by web browsers such as Google's Chrome, may forecast how other companies offering powerful chatbots begin approaching privacy. Perhaps giving users the ability to decide which queries they'd like to keep private will keep them coming back with more queries that will be offered up for training.

Such an ability could also appeal to users who are concerned about potential data security issues. One such problem popped up in March, when OpenAI temporarily shut down ChatGPT after receiving reports of a bug that allowed some users to see the titles of other users' chat histories.

The San Francisco-based startup will still store data, including conversations where users have turned off the chat history, for 30 days, which the company says it does to spot abusive behavior. For individuals, it also will keep training its models on user data by default. Given consumers' tendency to stick with any technology's default settings, it seems likely that most will continue to feed ChatGPT data without giving it a second thought. —*Rachel Metz*

THE BOTTOM LINE It's still early in the search to find a balance between AI's insatiable hunger for human-generated text and the human desire to maintain some privacy and control.

A Hit App Is Dragged Down by Its Chinese Roots

● Bondee's collapse shows the challenge Chinese apps face in major Asian markets

For a short stretch early this year, Bondee seemed on track to be the next hot app in some of the biggest markets in Asia. Millions of young people were drawn to the idea of creating cute avatars and hanging out in one another's "virtual plazas," and users described it as a mixture of the video game *Animal Crossing* and Meta Platforms Inc.'s sWhatsApp messaging service. It topped download charts from Singapore to South Korea.

Then things began to unravel. The trouble started with unsubstantiated rumors of credit card data leaks, which Bondee's developer, Metadream Tech Pte Ltd., denied. Some users also began pointing out Bondee's uncanny resemblance to the defunct Chinese app Zheli, better known as Jelly. That app, which briefly went viral in China in early 2022, had vanished from Chinese app stores amid reports of glitchy service and questions surrounding privacy. When internet users in South Korea dug up government records showing that Metadream had registered in South Korea as Chinese, Bondee's developers found themselves trying to refute charges that their big hit was just a way to relaunch Jelly while obscuring its origins.

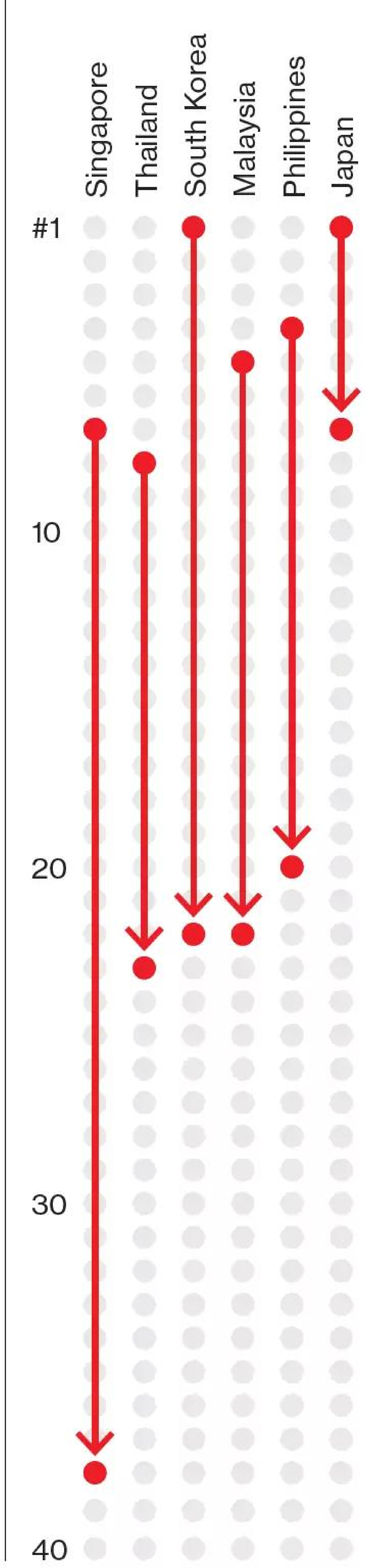
Metadream, which said it was based in Singapore, explained that it had acquired the rights to Jelly from its previous owner, True.ly of China. While Metadream is incorporated in Singapore, most of the startup's employees were in China, and it shared legal and finance staff with Jelly's Chinese owner as of February, according to a person familiar with the matter, who asked not to be named discussing private business. Metadream was led by Yang Yuxiang, an influential financier in China who spent two decades working for state-backed investment firms. He was listed as a director in Metadream's regulatory filings in Singapore but has recently been removed.

In any case, the damage was done. Many users didn't just abandon Bondee, they also started sharing social media posts on how to delete accounts and uninstall the app. By March downloads from the iOS App Store and Google Play Store plunged to 400,000, from 2.6 million in February, according to data compiled by Data.ai Inc.

In part, Bondee's story illustrates the faddish nature of smartphone apps. Some users said they simply got bored with it. One of its key features was to organize itself around social groups with a maximum of 50 members, which distinguished it from the largest social media platforms. "That was both its value proposition and its Achilles' heel," says Lim Sun Sun, a professor of communications and technology at Singapore Management University. "There were simply too few people to generate traction."

But Bondee's unusually swift rise and fall also underscores a key difficulty facing Chinese companies with ambitions to reach beyond the country. The prime example of this, of course, is ByteDance Ltd.'s TikTok, which India banned in 2020 and which is now at the center of a political firestorm in the US.

▼ Change in Bondee download rank among social apps from February to March 2023



The US controversy over TikTok's national security implications seems largely disconnected from the grassroots enthusiasm for the app itself. In major Asian markets such as Japan and South Korea, though, many users express a deep-seated skepticism for services originating in China, in part because of their countries' long, complicated histories with Beijing. "Bondee's nationality controversy and security fears blew up, especially with TikTok fresh in people's minds," says Kim Myuhng Joo, a professor of information security at Seoul Women's University. "There's a lesson for other companies."

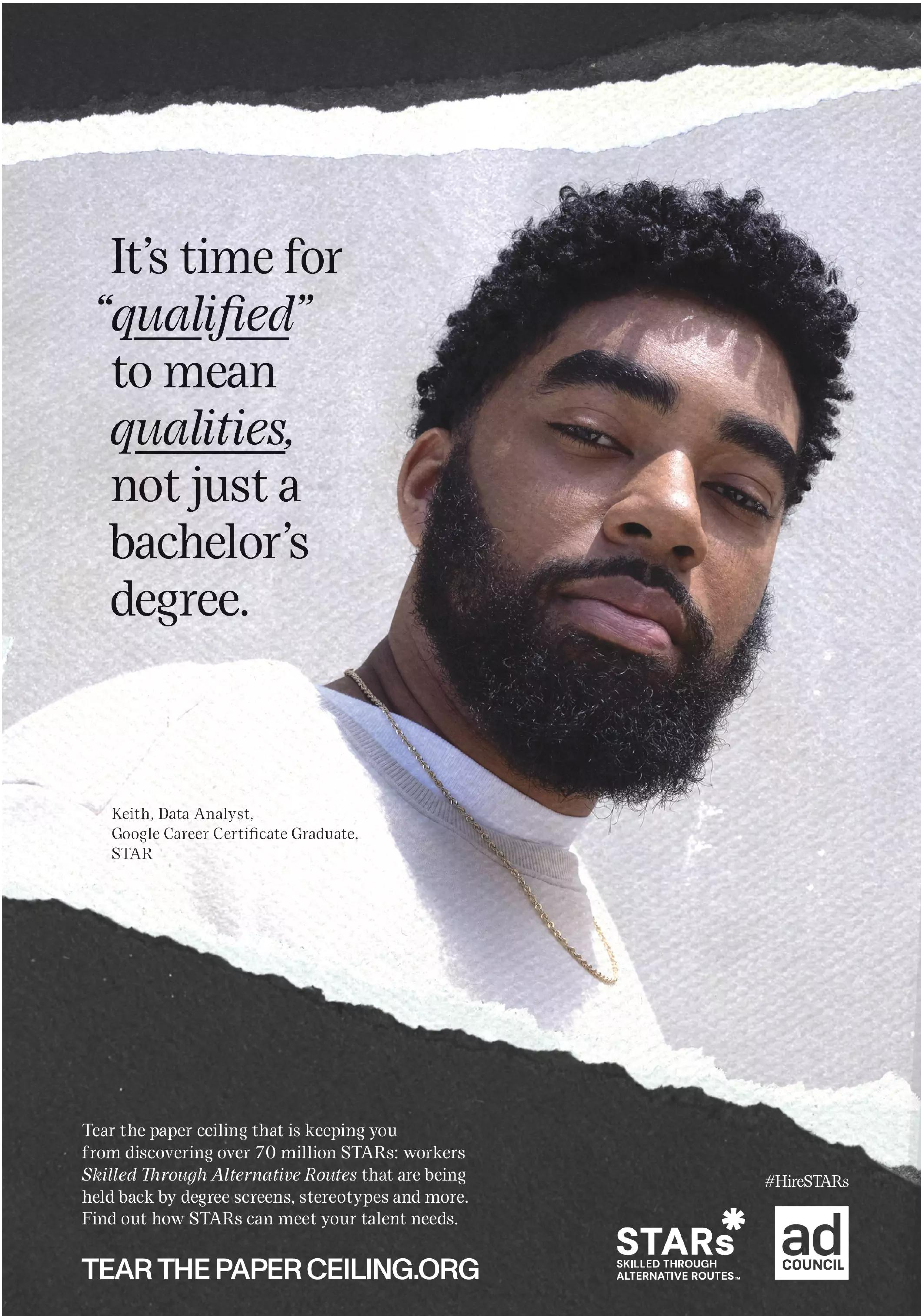
Users in South Korea criticized Bondee for collecting too much personal information, such as international mobile equipment identity numbers, unique to each mobile device and used by cellular networks to track them. Some expressed concern that the Chinese government could compel Metadream to share sensitive data about its users. The company issued one statement after another to address the allegations. It reiterated on its website that it was based in Singapore and said it had set up three independent data centers in the city-state, as well as in Japan and the US, to ensure data security and compliance with regional information security laws. Metadream said in a statement posted on Feb. 15 that it was registered as a Chinese company in South Korea because the process was handled by its Hong Kong unit after acquiring China's True.ly. It acknowledged that Bondee was based on Jelly but noted it had "developed the creative concept further and internationalized the app, launching Bondee as a next-generation social app." Metadream declined an interview request and didn't respond to emailed questions.

After witnessing the intense scrutiny TikTok has faced in the US and elsewhere, many Chinese startups have been trying to distance themselves from their origins and emphasizing their global nature, or even hoping to pass as local companies in the markets they target. Singapore, which has long played a neutral role in international affairs, is a natural location for Chinese companies seeking a new base. Companies that have moved their headquarters to Singapore include Shein, the popular fashion retailer, as well as TikTok, which has its main offices there and in Los Angeles.

But there's a danger in doing things that make it seem like you have something to hide. The scrutiny highlights how sensitive young smartphone users in countries such as South Korea are to potential privacy and data security risks, says Kim Sangkyun, a professor at the graduate school of business administration at Kyung Hee University in Seoul. "They felt they were misled by Bondee," he says. "You can create the most aesthetically pleasing metaverse platform, but if people feel misled or unsafe, they aren't going to stick around and socialize. Trust is everything." —*Yoolim Lee, Low De Wei and Zheping Huang, with Marika Katanuma and Kevin Varley*

THE BOTTOM LINE A new smartphone app took off in Asian markets because of its clever combination of cutesy gaming and social features, then lost users who felt it was obscuring its origins.

ILLUSTRATION BY BRENDAN CONROY. DATA: DATA.AI. FIGURES INCLUDE IOS AND GOOGLE PLAY


It's time for "*qualified*" to mean *qualities*, not just a bachelor's degree.
Keith, Data Analyst,
Google Career Certificate Graduate,
STAR
Tear the paper ceiling that is keeping you from discovering over 70 million STARs: workers *Skilled Through Alternative Routes* that are being held back by degree screens, stereotypes and more. Find out how STARs can meet your talent needs.
TEAR THE PAPER CEILING.ORG
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What's Up With Chuck?

● Charles Schwab's financial supermarket has a bank inside it—and that's a headache now

Bob Thompson describes his retirement as quiet and happy. He lives in Indianapolis with his Welsh terrier, Stella, covering his expenses with savings he amassed over four decades as an accountant. He entrusts those savings to an advisory and financial planning firm, which in turn runs major parts of its business through a gold-standard mainstay of American finance: Charles Schwab Corp. "I had a really good impression of Schwab," Thompson says.

These days he has questions. Schwab has been buffeted by the crisis that's engulfed US banks since the failure of Silicon Valley Bank. Its shares shed a third of their value in March, the worst monthly drop since 1987. Given all the headlines about the Westlake, Texas-based company's woes, Thompson wondered if he should worry. "It was just scary, hearing that name more often," he says.

That Schwab is part of the bank drama at all surprised many people. Ask what kind of business Schwab is, and you'll almost certainly hear that it's a stock brokerage. Or a wealth manager. Or a mutual fund company. But at the heart of the business there's also a bank—in fact, it's one of the nation's largest, with deposits of more than $300 billion. The bank is a landing place for money that's not in the market and provides checking and ATM cards, helping make the company a one-stop financial shop for its 34 million largely affluent customers.

Thompson ultimately concluded there was no reason to freak out. Securities held at Schwab—stocks and bonds, mutual funds, money-market shares and the like—are legally segregated from the company and are insulated from whatever happens in the bank. And bank accounts are protected by the Federal Deposit Insurance Corp. up to $250,000 per depositor, per bank and account type. (So couples with both single and joint accounts, for example, have even more coverage.) Schwab says 86% of its accounts are under insured limits.

Schwab's executives like to call the company "a safe port in a storm" for its clients. But its bank unit now has Schwab itself navigating choppy waters. Like other banks, it's seen the value of its assets fall as interest rates rise—with about $28 billion of unrealized losses sitting on its balance sheet at the end of last year. At the same time, depositors have moved their money in search of higher yields. Schwab is no SVB: Its customers aren't concentrated in the ▶

PHOTO ILLUSTRATION BY 731; PHOTO: BLOOMBERG

Edited by Pat Regnier

◀ jumpy world of tech startups, and a far greater percentage of its deposits are insured, so it's not as vulnerable to a quick run for the exits. What Schwab faces instead is a slower-moving problem with no easy solution. Its bank could now be considered a burden, when before it was a key part of its success.

If Schwab were a store, it would be Walmart. It's everywhere, and it's packed with choices. Want to invest in Apple Inc. stock? Use a Schwab brokerage account. Need help saving for college? Talk to a Schwab adviser at one of its more than 400 branches. Looking for a cheap index investment? You can buy a Schwab exchange-traded fund, even if your broker is Fidelity or someone else. And you can easily buy other companies' funds from Schwab's site, too. Also akin to a big-box chain, it owes its success to one core principle: low costs.

Charles Schwab founded his eponymous company in the 1970s and made it a foil to Wall Street brokers. Taking advantage of the deregulation of brokerage commissions, he offered a steep discount on trading costs compared with what rivals charged and appealed to investors who wanted to pick stocks themselves rather than take advice from salespeople. As more Americans were pulled into investing by individual retirement accounts and a long stock market boom, Schwab flourished, because it recognized that even folks with money to spare don't like to feel like they're paying too much.

When Schwab veered a bit from that ethos in the dot-com bust and charged higher prices than competitors such as ETrade and Ameritrade, the founder himself swooped back into the business, replacing then-Chief Executive Officer David Pottruck. He set about cutting costs, and the company launched its folksy "Talk to Chuck" ads. Schwab introduced its bank in 2003. As the discount brokerage model became the way most people bought stocks, commissions across the industry kept falling. In 2019, Schwab followed the lead of upstart trading apps like Robinhood and dropped commissions to zero. That relentless drive to knock down prices is, in some ways, the root of Schwab's present trouble.

If you ever wondered how the company makes money offering free trades, the bank is a big part of the answer. Schwab earns much of what it makes from "sweep" accounts, which hold uninvested dollars that are pushed from brokerage to bank accounts overnight. Schwab reinvests this cash, making a profit on the difference between the interest rate it pays the customer and the rate it earns.

After it began offering free trades, Schwab acquired TD Ameritrade. Then the pandemic set in, and retail trading went wild. Volumes at Schwab hit records. Deposits climbed, and the company needed to invest them. It plowed money into government bonds and US agency-backed mortgage securities. But when the Federal Reserve set out in 2022 on an aggressive campaign to curb inflation, interest rates rose sharply. Bonds fall in value when rates rise, so Schwab's portfolio took a hit even though its credit quality was high.

Meanwhile, its depositors started shopping around. They're the type. "Schwab has traditionally appealed to the self-directed investor—someone confident and sophisticated enough to make their own investment decisions," says Jim Angel, a finance professor at Georgetown University. The company now pays customers 0.45% on its default cash deposit vehicles. But it's easy to earn 10 times that in a money-market fund or a certificate of deposit. And since Schwab is a financial supermarket, you can make that switch right on the company's website. In Wall Street jargon, when customers look for better yield on their uninvested dollars, it's called "cash sorting," but it's also common sense. It's behavior that's typical of Schwab's vigilant customers—in fact, the company says it encourages such reallocations.

Bank deposits at Schwab fell by $41 billion, to $325.7 billion, in the first three months of 2023—an

▲ Schwab in 1981

▼ Bank deposits at Schwab

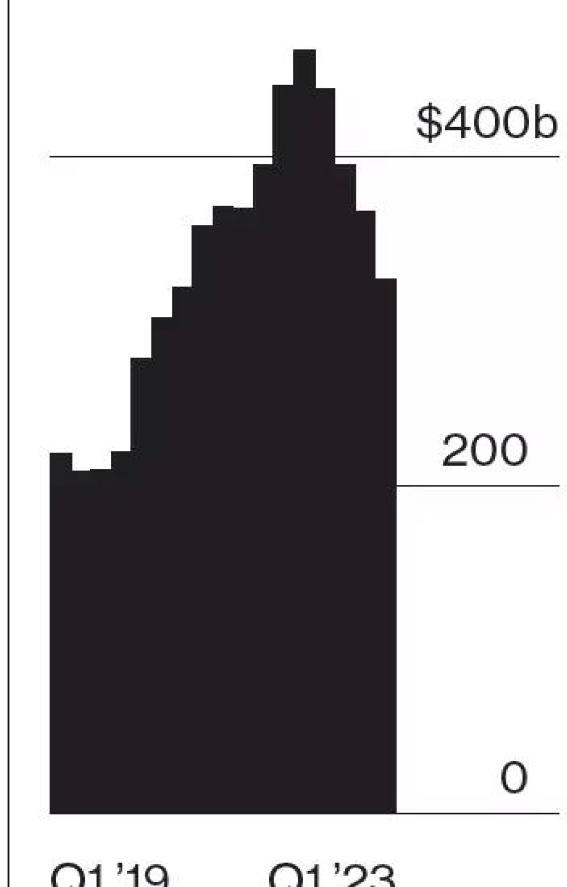


ILLUSTRATION BY SUJIN KIM. SCHWAB: ROGER RESSMEYER/GETTY IMAGES. DATA: COMPANY FILINGS

11% decline. Over the past year, deposits are down 30%. The company is shoring itself up by borrowing money at higher interest rates, becoming the largest borrower from the Federal Home Loan Bank of Dallas. It had borrowed a total of $45.6 billion from the FHLB by the end of March, up from $12.4 billion at yearend. Schwab had borrowed nothing from the FHLB system at the end of 2021. Wall Street worries this can't be sustainable. Executives at Schwab say such borrowing is temporary.

Schwab is still profitable—it recently reported a 12% jump in adjusted net income. Executives say the customers' cash movements already show signs of subsiding. CEO Walt Bettinger and a group of Schwab executives told investors on a call following the latest earnings report that customers tend to move cash out of sweep accounts in big, one-time chunks. They added that the assets usually stay within Schwab's ecosystem, even when customers draw down deposits. Still, the company earns more on sweep accounts than it does on fees for money-market funds.

It's not the first time Schwab's treatment of customer cash got an awkward moment in the spotlight. Last year the company paid $187 million to regulators to settle allegations that its no-fee online "robo-adviser" service dragged down customer returns by allocating too much to cash. Schwab neither admitted nor denied the charges.

Schwab's leadership has said there's a "near-zero" chance they'd need to sell any of their hundreds of billions of dollars of debt securities before they mature. They say Schwab has plenty of cash flowing in to bolster liquidity and point to $300 billion of other funding sources, including its line of credit from the FHLB and the emergency support the Fed has offered all banks since the SVB collapse. Other sources of funding include CDs. Some $19 billion in Schwab CDs were sold via rival brokerages—inflows that buttressed its investor-services assets in the first quarter.

Where does Schwab go from here? One analyst toying with that question suggested it could offload its bank entirely as a last resort. Bettinger shot down that idea in an interview on CNBC. "It's not something we're going to look at in the short run," he told the network. Schwab's bank is almost certainly going to face a new regulatory landscape. The blowups of SVB and later Signature Bank have increased scrutiny of lenders that previously weren't considered too big to fail. "We expect a high likelihood of regulatory change," says Kyle Voigt, an analyst at Keefe Bruyette & Woods Inc.

Angel, the Georgetown professor, says investors holding Schwab shares will likely reassess the company's prospects. But its customers? Angel is among their ranks, and he's not moving his money away from Schwab. He says he's confident knowing his deposits are FDIC-insured. "Let me put on my Schwab-customer-since-1983 hat," Angel says. When it comes to the issues facing Schwab, "I don't really give a bleep." —*Annie Massa*

Schwab is shoring itself up by borrowing money at higher interest rates. Wall Street worries this can't be sustainable

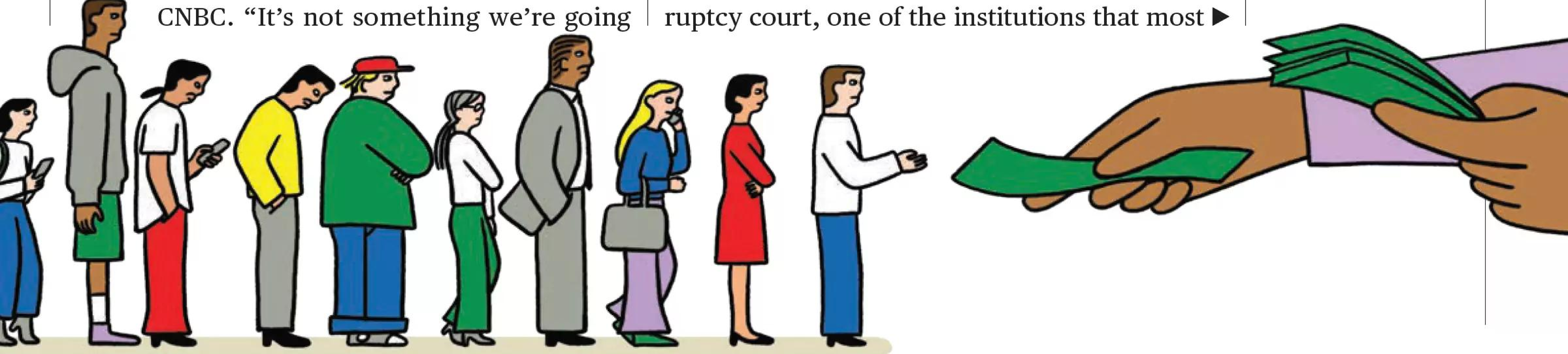
THE BOTTOM LINE Schwab is facing dwindling deposits in its banking business, in part because it has the kind of customers who know how to shop around.

When Crypto Meets Bankruptcy Court

● Investors in broke companies want their coins back, but instead they get a place in line

Some retail investors piled their money into crypto for its anti-establishment qualities. Avoiding big banks or hidebound regulators sweetened the taste of uncanny returns. Crypto firms stoked that sentiment, pulling in money by promising a world of "unparalleled economic freedom," as Celsius Network put it, or by vowing to make "crypto for all" a reality, in the words of Voyager Digital.

But now millions of crypto fans—and their money—are trapped in a different kind of reality. Companies they trusted with their cryptocurrency have failed, and their assets are stuck in bankruptcy court, one of the institutions that most ▶



◀ stands for bureaucracy and the establishment. How much money the investors lose will be set by judges enforcing complex rules written long before the first crypto coin was minted.

The process has already led to angry clashes on Zoom, where bankruptcy court hearings moved during the pandemic. Alah Shehadeh, who invested $80,000 on the Voyager platform, was thrown out of a key hearing in March after repeatedly interrupting the judge, lawyers and witnesses. At one point he shouted, "You are a terrible judge. You are robbing us. This is a crime." Like many of his fellow investors, Shehadeh no longer owns much of the crypto or the traditional currency he deposited with Voyager, according to court documents. Instead he owns a right to collect money owed to him by the company. Although that sounds like much the same thing, there's a crucial distinction: If a company doesn't have enough money to pay everyone 100% of what it owes, in bankruptcy the debt holders end up standing in line for their smaller piece of whatever is left.

That's an especially bitter pill for those who believed crypto was meant to be empowering. "I hate being bullied, and in this case it's not bullying per se—but it's legalized bullying," says Daniel Frishberg, a creditor in the Chapter 11 case of Celsius Network. Celsius, like Voyager, allowed customers who deposited their crypto coins to lend them out and earn high yields. It collapsed in 2022 as digital asset markets tumbled. "They're coming in with a bankruptcy petition and saying, 'It's our money now, and you can't do anything about it,' " he says.

Frishberg has filed dozens of objections, motions and letters, often second-guessing the lawyers running the case and key rulings by Judge Martin Glenn of the US Bankruptcy Court in New York City. "I'm doing it for the principle at this point," says Frishberg, a 19-year-old student at the University of South Florida. He reflects the frustration of many investors, who argue that the digital assets they deposited are their property, even if customer agreements they signed say otherwise. In a ruling that could set a precedent, Glenn found Celsius owned the assets of customers who had interest-bearing accounts. What the customer got in exchange was, he ruled, essentially an IOU from Celsius.

Many crypto investors didn't realize the money and digital coins on digital lending platforms are often treated like traditional bank deposits. Instead of holding depositor dollars for safekeeping, the bank takes the money, pools it with everybody else's cash and then lends it out or invests it in some other way. There's one big difference: If a bank fails and there isn't enough money to repay everybody's deposits, customers are protected up to limits set by the Federal Deposit Insurance Corp. Crypto deposits aren't protected.

Some customers of the failed crypto platforms have taken the bankruptcy legalese as a challenge, spending dozens of hours a week wading through filings and hearings. One Telegram chat group has more than two dozen creditors who regularly communicate with one another. Immanuel Herrmann, an active creditor who's represented himself in court, organized more than 500 creditors to sign a letter opposing a motion to give Celsius more time to file a reorganization plan. "They understand crypto better than anyone," says David Adler, a lawyer who represents a group of creditors in the Celsius case. "But the problem is translating that into the legal principles that the court has to apply."

The shock these investors are experiencing stems from the way crypto firms pitched their products. "Our mission: To put unparalleled economic freedom in the hands of the people. Join the revolution, join Celsius and unbank yourself!" was one way Celsius marketed itself.

Other companies boasted that they were licensed to do business by various states. Before it went bankrupt in November, the crypto lender BlockFi told customers that it was "regulated under US law" and that "we play by the rules." But there are few significant federal regulations designed to protect investors in cryptocurrencies. The company faced scrutiny from financial regulators over its yield-paying accounts and in February 2022 agreed to pay $100 million in penalties to the US Securities and Exchange Commission and several US states. The SEC alleged that BlockFi's yield product amounted to an unregistered security; BlockFi settled without admitting or denying the charges.

Voyager is likely to be the first of the crypto firms that went bankrupt last year to begin repaying customers. Under its court-approved plan, customers would get about half of what they're owed, according to a January court filing. The value could go up or down, depending on the cryptocurrency price at the time the customer cashes out.

Not everyone who put money into the bankrupt crypto companies has a libertarian bent. But hints of that philosophy can be found in letters written to bankruptcy judges. "Crypto is not just money—it's freedom," one creditor wrote in January to Glenn, the judge in the Celsius case. "This is what Celsius sold us—led us to believe, and I wholeheartedly believed it. It wasn't just about investment, it was about the revolution."

Shehadeh, the Voyager creditor, says his goal

ILLUSTRATION BY PATRIK MOLLWING

had been to make money to pass on to his children. But his crypto investments have so far cost him a house in California, and the stress is threatening to destroy his marriage, he says: "It's a huge loss for a lot of people, not just me." —*Steven Church and Amelia Pollard*

THE BOTTOM LINE Crypto-lending companies took investors' money and pooled it to make investments. When they went broke, customers became creditors hoping for a piece of the remains.

The Other Backstop For Banks

● When lenders are under stress, Federal Home Loan Banks can offer help without the stigma

The US banking panic that unfolded in March could've been a lot worse if it weren't for the Federal Home Loan Bank system. These government-sponsored but privately funded institutions provided hundreds of billions of dollars to banks when depositors were pulling their cash.

The FHLBs played a role a little like that of the Federal Reserve. The Fed is a lender of last resort: Its "discount window" is a place where banks go when they can't get cash anywhere else. The less well-known FHLB system is more like a next-to-last stop. Borrowing from it can cost banks more than using the Fed, but it doesn't come with the stigma of signaling an emergency.

A legacy of the Great Depression, the network of 11 regional FHLBs was set up by Congress to support homeownership. While it still supports a big chunk of the nation's property lending, it's evolved into a linchpin of the broader funding market for banks. Almost 6,500 institutions, from small savings banks to giants such as JPMorgan Chase & Co. and Citigroup Inc., are members of the co-ops that own and use each FHLB. Commercial banks were allowed to pay into the system as part of legislation to mop up the 1980s savings and loan crisis.

Even before Silicon Valley Bank and New York's Signature Bank failed, there were already signs that banks were tapping FHLBs to replace deposit outflows as savers responded to rising interest rates by seeking better yields. FHLBs' advances to members—short-term loans secured by mortgages or other assets—more than doubled in 2022, to $819 billion.

● Outstanding advances from the FHLBs as of Dec. 31

$819b

On Friday, March 10, when the Federal Deposit Insurance Corp. took over SVB, requests for advances took off as other banks sought buffers. The FHLB responsible for institutions in New York and New Jersey saw activity that day approximately nine times the Friday volumes it had experienced in recent weeks. Members called over the anxious weekend to prepare for Monday in the event of a broader depositor flight, which turned out not to be as bad as some had feared. To meet record advance requests, the FHLBs' Office of Finance raised $179 billion on March 13 alone by selling notes to investors—and raised $304 billion in debt that week. By some Wall Street estimates, outstanding advances may have climbed to $1.1 trillion.

"In times of darkness and despair, the Federal Home Loan Banks are open, like the post office," says Christopher Whalen, chairman of Whalen Global Advisors, a financial consulting firm.

Some raise concerns about the FHLBs' growing role beyond housing. The FHLBs should consider how reliance on them might "enable banks to pay too little heed to liquidity and potentially other risks when times are good," says Kathryn Judge, a law professor at Columbia University.

Joshua Stallings, the deputy director for bank regulation at the Federal Housing Finance Agency—the watchdog for the FHLBs—wrote in an email to Bloomberg News that while the system "has a strong reputation" of providing liquidity, "it is not intended or structured to function as a lender of last resort." There are limits, he added, to how much help FHLBs can provide, but what happened in March was far from typical. —*Alex Harris, with Austin Weinstein*

THE BOTTOM LINE A system of government-chartered lenders set up to encourage mortgage lending is also a source of liquidity for banks, which turned to it after SVB failed.

The Loneliness Of America First

Policies designed to bolster US capabilities in leading-edge industries are causing friction with allies

Edited by Cristina Lindblad

When French President Emmanuel Macron arrived in Washington for a state visit in December, he groused that it's not in America's interest if much of Europe's industry is "just killed." South Korean President Yoon Suk Yeol, who visited the White House on April 26, has warned of a widening "economic war" of government subsidies and tax perks that could leave all nations worse off.

Both were expressing alarm at the international fallout of the US-China rivalry and President Joe Biden's Made in America policies. Europe and South Korea—important trade and security partners for the US—are among the most exposed to the Biden administration's two-pronged agenda of supporting strategic industries such as electric vehicles, semiconductors and artificial intelligence while working to hobble China's efforts to make advances in those same fields for military purposes.

America's newly muscular industrial policy is already warping global supply chains. A pair of laws Congress approved last year together offer about $420 billion in funding to incentivize the domestic production of chips and clean energy technologies. Add the infrastructure bill Biden signed in 2021, which requires that all iron, steel and other construction materials used in public-works projects be made in the US, and you've got about $2 trillion in federal spending over 10 years.

One effect of all this cash sloshing around—intended or not—is that overseas businesses feel a gravitational pull toward the US to tap the funds available under the Chips and Science Act and the Inflation Reduction Act (IRA). For instance, Swedish battery maker Northvolt AB has said it is prioritizing expansion in the US over Europe. German carmaker Volkswagen AG already opted in March to build a $2 billion factory for its new electric Scout brand in South Carolina, describing the incentives on offer as akin to "a gold rush."

The diversion of corporate investment is one consequence of the Biden administration's efforts to integrate domestic and foreign policy in what National Security Advisor Jake Sullivan has called "a modern industrial and innovation strategy" that creates jobs at home while projecting American strength abroad. To advance those goals, Washington is prepared to wield sticks as well as carrots. Sullivan has described export controls as "a new strategic asset" to impose costs on adversaries in the name of national security.

The upshot is that South Korea—whose largest trading partner is China—risks getting whacked on at least two fronts. Companies including Samsung Electronics Co. and SK Hynix Inc., the world's two largest memory chipmakers, were granted a one-year reprieve from US export controls on supplying advanced semiconductor technology to China. It remains unclear what happens when that runs out this October.

Seoul has also expressed concern that Hyundai and other South Korean car marques will be penalized by the IRA because they don't manufacture EVs in the US, meaning their models don't qualify for federal tax credits on EV purchases (page 32). The chief executives of Samsung and Hyundai Motor Co. both accompanied Yoon on his trip to Washington.

Even as he warned that supply chains were being upended by a global race to build out cutting-edge manufacturing facilities, with each country "sparing nothing" to bring industry home, Yoon in March announced South Korea's intention to jump into the fray with a 550 trillion won ($413 billion) investment plan focused on public-private partnerships in chips, batteries, robots, EVs, displays, biotechnology and other areas.

Seoul is not alone: From The Hague to Tokyo, governments are compelled to bend to Washington's will or respond in kind. On April 18, the European Union approved a €43 billion ($47.2 billion) Chips Act that opens the door to state funding for the likes of ASML Holding NV, a Dutch manufacturer of chipmaking equipment whose exports to China have been curtailed at America's behest. The EU is also lining up massive subsidies to counter the impact of the IRA, which carries close to $370 billion in funding to help the Biden administration meet climate goals. In Canada, Justin Trudeau's government dangled incentives worth as much as C$13 billion ($9.5 billion) over a decade to land a Volkswagen battery plant that might have been destined for the US.

While Seoul is willing to go along with the US on matters of national security, there is still "deep concern" among Korean private companies over what's seen as "discriminatory" elements in Biden's policies, said Wonho Yeon of the Korea Institute for International Economic Policy, speaking at an April 18 forum organized by the Wilson Center to mark Yoon's visit.

China is redoubling efforts to advance its semiconductor industry in the face of what President Xi Jinping calls US attempts at "containment." Xi recently urged on Chinese tech companies, saying innovation is key to achieving "high-level technological self-reliance."

With both China and the US engaging in "this new economic statecraft," third countries "are facing a dilemma in keeping the balance between domestic politics and foreign policy," said Miyeon Oh, director of Korea Studies at Johns Hopkins ▶

● Funding in the Chips Act and the IRA

$420b

ILLUSTRATION BY ARIEL DAVIS

◀ University's School of Advanced International Studies at the April 18 event. "Frictions" between allies, including over the IRA, should be seen as part of a "learning process," she said.

With their deep pockets, the EU, Japan and Korea can at least afford to go some way to matching the US. Others cannot. The UK, with its economy sputtering, has little new funding in its response to the IRA.

In a lengthy critique of Biden's industrial policy published in *Foreign Policy*, Adam Posen, president of the Peterson Institute for International Economics, called the approach ultimately "self-defeating" because it's based on "four profound analytic fallacies: that self-dealing is smart; that self-sufficiency is attainable; that more subsidies are better; and that local production is what matters."

There are signs the administration is tweaking its policy to address some of the concerns raised by allies. Washington and Tokyo struck a deal in March to allow critical minerals sourced in Japan to qualify for IRA subsidies, despite the countries not having a free-trade agreement (FTA). The EU, which has tempered its initial criticism of the US measures, is in talks for a similar arrangement. (To qualify for incentives offered in the IRA, automakers must not only build their EVs in the US but will also need to certify that components come from the US or FTA partners.)

In another sign that the Biden administration is trying to be accommodative, a loophole has been carved into the IRA that allows Hyundai to access full US subsidies for rental and leased EVs, a market that makes up more than 25% of its US sales. Samsung has submitted a statement of intent to tap chip subsidies for an advanced plant it's building in Texas that's due to start production in 2024, *Dong-A Ilbo* newspaper reported April 19.

It's surely an irony not lost on Yoon that South Korea was seen as the country most at risk from Xi's industrial master plan for China when it was unveiled in 2015. The blueprint, called "Made in China 2025," trumpeted Beijing's ambitions to lead the world in 10 future-oriented industries, including robotics, pharmaceuticals and aerospace. Its focus on "self-sufficiency" contributed to the souring of relations with the US, Europe and Asia.

The US strategy laid out by Sullivan has echoes of that plan, with goals to maintain and defend America's lead in three "force multiplier" areas: computing, including chips and AI; clean tech; and—the administration's likely next focus—biotech and biomanufacturing. The risk is that it has a similarly alienating effect.

Biden is already touting the creation of new US jobs as a result of these policies as his campaign for reelection next year gears up. Call it "Made in America 2024." —*Alan Crawford, with Sam Kim*

THE BOTTOM LINE The Biden administration's Made in America push has sparked a worldwide subsidies arms race that may leave the US more isolated.

What's Making Inflation So Sticky?

● Economists don't agree on what's keeping prices from falling faster

More than a year after the Federal Reserve unleashed a barrage of interest-rate hikes to tame inflation, price pressures are moderating, though not as quickly as policymakers would like. As recently as March, officials on the central bank's rate-setting committee were forced to raise their outlook for core inflation, as measured by the personal consumption expenditures price index, this year to 3.6% from the 3.5% they'd projected back in December, underscoring how their 2% target remains elusive.

Economists continue to debate what's keeping inflation high—or "sticky," in professional parlance—even as borrowing costs have surged. The issue is that while prices for food, everyday household goods and energy have moderated, those for many services have continued to rise. Shelter, which amounts to about a third of the consumer price index, clocked a 0.6% increase in March, which was an improvement over the previous month. But costs for other services including air travel, education and car insurance continued to climb.

DATA: BUREAU OF LABOR STATISTICS, BUREAU OF ECONOMIC ANALYSIS

Fed Chair Jerome Powell has cited higher labor costs in service industries as one of the reasons inflation is staying sticky. Health-care employment costs rose by the most of any industry in the last quarter of 2022 and are at an all-time high. The US is currently down some 260,000 nurses and residential-care workers from pre-pandemic levels, a deficit that's given rise to the term "Nursemageddon." Burnout and retirements mean the shortage is expected to worsen in coming years, with almost 1 million nurses projected to leave the profession by 2027, according to estimates by the National Council of State Boards of Nursing.

Not everyone buys the argument that there is a link between a tight labor market and stubborn inflation. Omair Sharif, founder of Inflation Insights LLC, says wage demands by workers in services such as auto repair or air travel are no more of a problem for employers in those industries than, say, shortages of car parts or higher fuel prices. "Labor costs are clearly important, but in general, higher costs across the structure of each business are just as important, if not more important, to the rise we saw in inflation last year," he says.

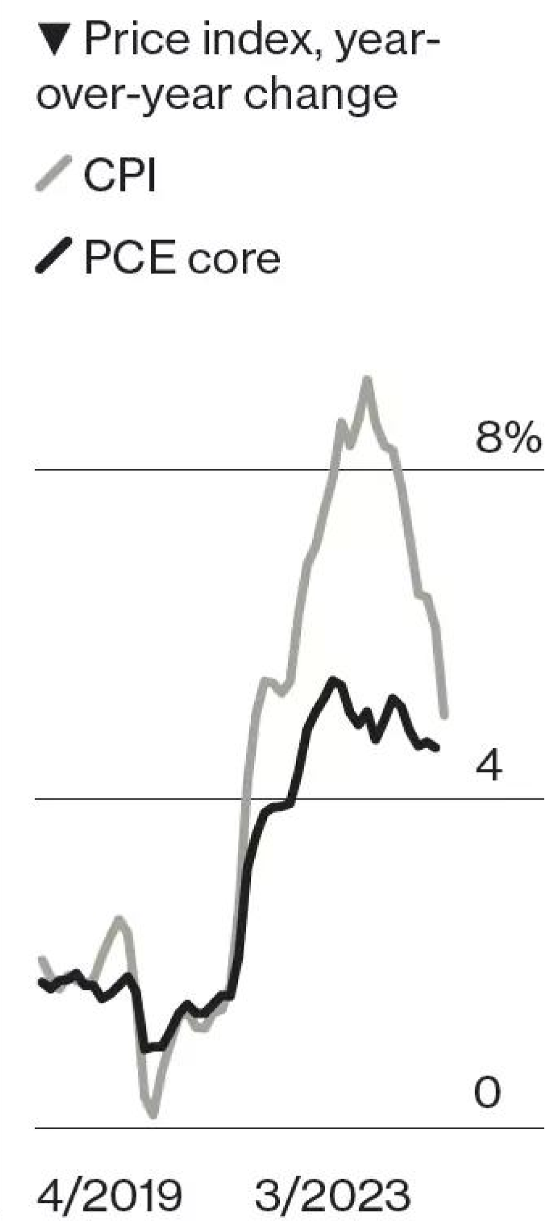
A recent analysis by Employ America, an advocacy group, found that core inflation indicators show wage growth is in fact slowing. "We are getting back to the point of where we are within the range of pre-pandemic levels of wage growth," says Preston Mui, an economist at the group.

However, a gauge of wage growth from the Atlanta Fed showed wages rose 6.4% in February from a year earlier, outpacing the increase in the CPI for the first time since the pandemic began. Other data show median weekly earnings of full-time wage and salary workers were 6.1% higher in the first quarter of 2023 compared with the same period last year.

An analysis of the major CPI components by economists at Nomura Holdings Inc. posited that inflation could slow faster than the market expects this year—but that the bigger challenge will come in 2024, when CPI inflation may remain above 3%. Besides wages, so-called structural factors such as constrained supplies of goods and energy, shifting production chains and geopolitical tensions are among the reasons economists cite for why inflation may stay higher for longer.

How these dynamics play out will determine whether inflation returns to the Fed's comfort zone without a recession or proves more persistent than expected—forcing the central bank to push interest rates up, which could result in an economic downturn. Traders are banking on another 25-basis-point hike when policymakers next meet May 2-3. "We still have a long way to go in terms of bringing down inflation, and the path to do that is not going to be pretty," says Sarah House, a senior economist at Wells Fargo & Co. —*Enda Curran, with Augusta Saraiva*

THE BOTTOM LINE Inflation in services is proving more stubborn than that in other areas, but it's not certain whether wage pressures are playing a leading role in keeping health care and other costs high.



China on The Mend

● Growth accelerated markedly in the first quarter, though some areas of the economy show signs of pandemic scarring

China's economy looks to be on pace to return to its pre-pandemic growth trend by the end of 2023. The National Bureau of Statistics published data on April 18 showing that gross domestic product expanded 4.5% in the first quarter, fueled in large part by a spree of revenge spending by shoppers, travelers, diners and moviegoers. Households allocated more of their income to consumption and less to savings, a sign that consumers had recovered their nerve following Beijing's decision late last year to abandon Covid-19 controls, triggering a massive wave of infections.

Several investment banks and money managers promptly upgraded their 2023 growth forecasts to well above the government's official target of about 5%. Patrick Zwiefel, chief economist at Pictet Asset Management, is among the most optimistic. He's penciled in a 6.6% expansion for the full year, powered by an 11% jump in consumer spending.

China bulls can marshal an assortment of ▶

◀ data to make their case. There's the property market, which appears to be emerging from a prolonged slump. Sales of apartments rose in the first quarter—the first increase in 18 months—bolstered by government-mandated cuts to mortgage rates. And bank lending to companies has been breaking records, an indication that officials have stuck to their tried-and-tested playbook for boosting growth: credit-fueled investment.

But not all the statistics coming out of China are that upbeat. Household income growth appears too weak to power the double-digit jump in consumer spending Zwiefel is banking on. Inflation-adjusted urban wages were up just 2.5% in the first quarter, according to official sources; a survey of small and midsize companies carried out by brokerage CLSA Ltd. has them rising less than 1% over the period.

Many companies are unsure about their prospects and therefore reluctant to hire more workers. China's official unemployment rate dipped slightly this year, to 5.3%, but other data tell a different story. First-quarter listings on Boss Zhipin, a popular job website, were down 5% from the previous year, according to research group TH Data Capital, with the information technology sector showing the largest decline. Youth unemployment is hovering near a record high of 20%. The job market might take until 2024 to recover fully, says Yi Xiong, Deutsche Bank AG's chief China economist.

The rebound in the property market is also looking shaky. Sales in major cities slowed in April from the previous month, according to China Real Estate Information Corp. The government has instructed banks to step up lending to developers to make sure they complete existing projects, but builders are starting fewer ones. As a result, total property construction was down about 10% in the first quarter from a year earlier.

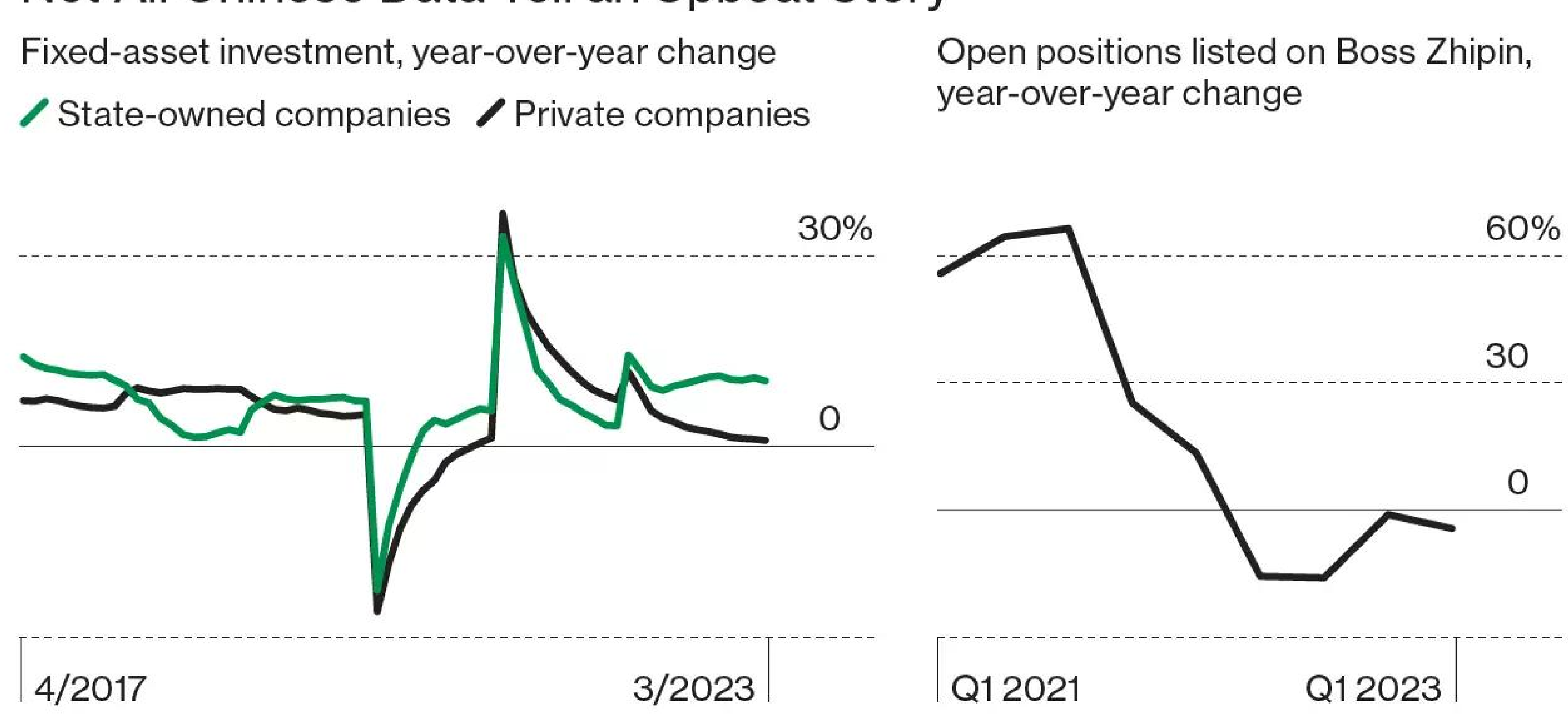
Although the market may eventually stabilize, Zhu Ning, a professor at the Shanghai Advanced Institute of Finance, rules out a return to the go-go days. Chinese households' view of housing as a safe store of wealth has been fundamentally altered—a victim of the government's crackdown on real estate speculation and developers' failure to deliver projects on time. "There is not a lot of hope in the sector for the next few years on a national level," Zhu says.

This bearish view accounts for why several economists have marked down their China growth forecasts for 2024 and beyond. Lu Ting, chief China economist at Nomura, says GDP growth may fall "sharply" next year and dip to 4% thereafter, assuming a US-led technological decoupling slows China's development.

The International Monetary Fund also has trimmed its long-term forecasts for China, arguing that even 4% growth will be hard to achieve after 2025. It says structural changes in the economy are sapping momentum. State-owned enterprises, which tend to be less efficient and innovative, are expanding in strategic sectors such as technology, while sudden regulatory changes have made privately owned companies reluctant to invest. Furthermore, consumer spending has lagged overall GDP growth, resulting in a shortage of demand for new production, which reduces the private sector's motivation to hire and invest.

Those trends were understandable when pandemic restrictions were in force, but they've continued even after lockdowns ended. The pace of private-sector business investment almost came to a halt in the first quarter, with nearly all additional spending driven by state-owned companies, while growth in consumer spending trailed GDP growth by about half a percentage point.

Not All Chinese Data Tell an Upbeat Story



DATA: NATIONAL BUREAU OF STATISTICS OF CHINA, COMPILED BY TH DATA CAPITAL

"There's a likelihood that the pandemic has permanently scarred household confidence and thus consumption," says Paul Cavey, an analyst at consulting firm East Asia Econ. "The first-quarter data keep that risk alive."

Nevertheless, it's important to place China in a global context: Even on its slower track, the country will contribute almost 23% of total global growth through 2028, according to Bloomberg calculations based on IMF projections—more than any other nation. That makes it a focus of corporate boardrooms worldwide. Zhu of the Shanghai finance institute reckons the world's No. 2 economy will account for a third of global growth this year. "China is still indispensably important," he says. *—Tom Hancock, with Fran Wang*

THE BOTTOM LINE With consumer and business confidence still fragile, China's economy continues to rely on credit-fueled investment to power growth.

+ SOLUTIONS

Consumers Clue In to The EV Tax Loophole

PHOTO ILLUSTRATION BY LISETT LEDON FERNANDEZ; PHOTOS: GETTY IMAGES (1); HYUNDAI (2). COURTESY HYUNDAI

Leasing is the simpler route to saving money on a battery-powered car, and more Americans are signing up

May 1, 2023

Edited by Rebecca Penty and David Rocks

Alistair Weaver is in a quandary over replacing his Tesla Model 3 with another electric vehicle when his lease expires in a few months. Weaver, who lives with his wife and two children in a Los Angeles suburb, likes driving an emissions-free vehicle to help reduce pollution. But he can't buy the next EV he wants—a $50,000 Hyundai Ioniq 5—and qualify for a $7,500 tax credit under the Inflation Reduction Act (IRA), because it's manufactured in South Korea and Indonesia.

To save money, Weaver is contemplating returning to a gas guzzler. Or, depending on the monthly payment, he's considering leasing a Hyundai Ioniq 5 instead of buying. The latter option would allow him to benefit from the tax

credit, because the new federal rules exempt leased vehicles from restrictions on where the car is made, where its battery materials come from and how much money the consumer makes. Those stipulations on purchased EVs are designed to promote North American production of battery-powered vehicles.

"Navigating what to buy and how to buy it is literally my day job, and this is so bloody complicated," says Weaver, who's editor-in-chief of automotive researcher Edmunds.com Inc. "EVs are just expensive—that's the fundamental challenge—and I don't want to pay through the nose."

Fewer than a dozen EVs qualify for the full $7,500 tax credit if purchased by a consumer. But all battery-powered models benefit from it if they're leased, because in that case the IRA categorizes them as commercial vehicles. The lease option is an IRA loophole you could drive millions of electric vehicles through. International automakers lobbied for and secured it after fearing they'd be shut out of the IRA tax credits aimed at stimulating the nascent EV market in the US.

These favorable factors are likely to make leasing the dominant way Americans gain access to EVs. Marion Harris, chief executive officer of Ford Motor Credit Co., the automaker's lending arm, expects 60% of EV drivers in the US to lease in the short term rather than buy, which is three times the 20% lease rate of vehicles with traditional internal combustion engines. "Leasing is a big piece of the Inflation Reduction Act," Harris says. "The non-US automakers are going to be doing a lot more leasing of EVs," and Ford Motor Credit is "going to be a big supporter for lease."

EV leasing has been on the rise since the US Department of the Treasury opened the loophole by characterizing leased EVs as commercial vehicles in December. Leases and rental cars—which also count as commercial vehicles—were 28% of Hyundai Motor Co.'s EV sales in the US during the first quarter, up from 5% in 2022, Choi Sang-mok, South Korea's senior presidential secretary for economic affairs, said in April. In March, the lease rate of the US EV market jumped to 34%, from 18% a year earlier, according to Edmunds data.

Columbus, Ohio, car dealer Rhett Ricart also sees EV leasing coming on strong. "Watch leasing jump thanks to the tax credit," says Ricart, who owns dealerships for Ford, General Motors, Hyundai and others. Automotive finance companies are busy "sweetening up the leases" as consumers clue in to the opportunity, he says.

For consumers, leasing is a "no-brainer," says Jessica Caldwell, executive director of insights for Edmunds. "Leasing allows you to have the credit applied immediately to your monthly payment, rather than waiting to get your money back next year when you file your taxes," she says. "Americans don't get quite as excited about waiting."

Not excited at all about the leasing loophole is Senator Joe Manchin, the West Virginia Democrat who put restrictions in the IRA to promote domestic production of EVs and batteries and prevent the tax credits from becoming a subsidy for wealthy car buyers. When the exemption was put in place, he said it "bends to the desires of the companies looking for loopholes and clearly is inconsistent with the intent of the law."

Congressional Republicans share Manchin's disdain, including House Speaker Kevin McCarthy, who proposed legislation in April that would strip away the credits entirely. The legislation, which is tied to raising the debt ceiling, is unlikely to pass, but it highlights GOP opposition to federal stimulus for EVs.

Even without the IRA, though, the case for leasing is growing. EV resale values are rising because of their ability to receive software downloads that can introduce safety technology or enhance the infotainment features in the digital dashboard. "There's always going to be another update that makes your vehicle better, such as the driver-assist system or new features or extending your mileage on a charge," says Harris of Ford Motor Credit. And higher resale values lead to lower lease payments because the car is worth more at the end of the lease.

A Hyundai Ioniq 5 being charged

Leasing also acts like technology insurance for customers who are concerned about replacing the battery on their electric car if it eventually runs dry and can no longer juice up. "If a consumer is concerned about the battery and what they're going to have to do with it, then lease it," says Jeff Schuster, president of the Americas for researcher LMC Automotive. "Then it becomes someone else's problem." —*Keith Naughton*

THE BOTTOM LINE US tax credits designed to spur domestic manufacturing of battery-powered cars are behind a consumer shift toward leasing, rather than owning, electric vehicles.

Helping E-Vans Deliver

New subsidies can make battery-powered vans price-competitive with diesel versions

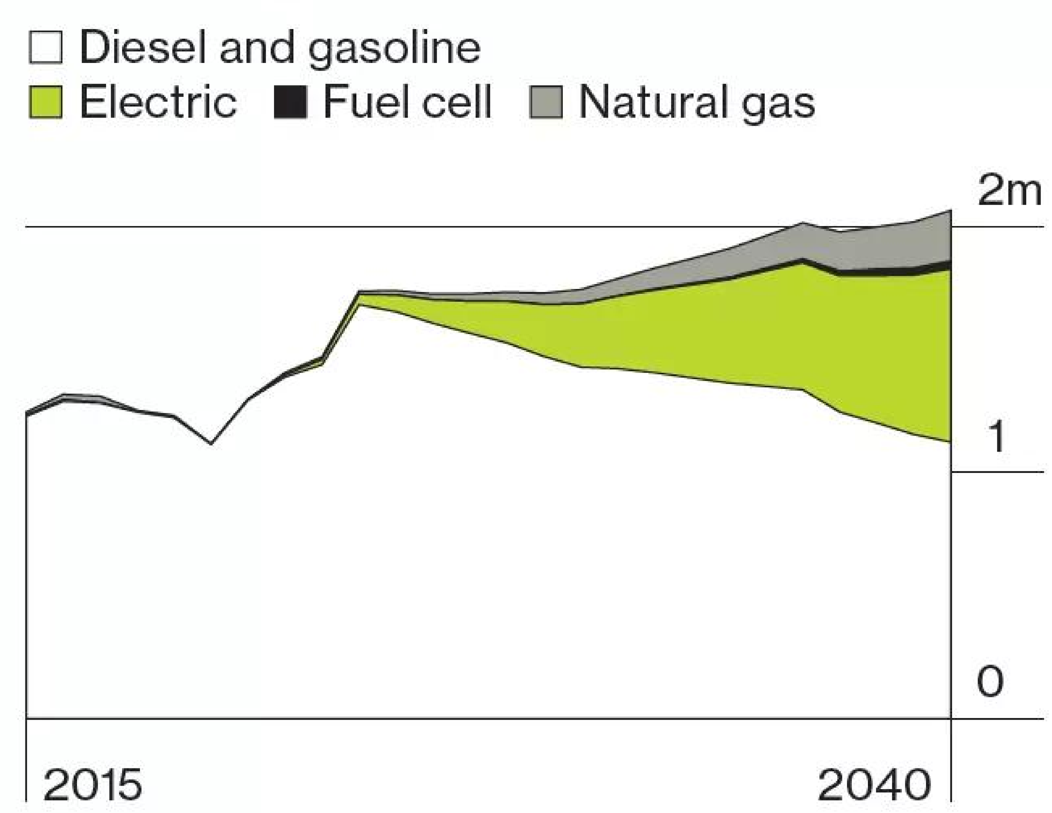
You can get a delivery truck—those boxy vans that companies ranging from FedEx Corp. to the local bakery use to shuttle goods from warehouses to homes and shops—for around $100,000. Lately, though, growing numbers of buyers are choosing to pay twice as much. The reason: The pricier ones are electric rather than diesel. And the cost of purchasing and operating the vehicle, after factoring in fuel savings, is fast approaching parity with traditional trucks. “The technology really works for this,” says BloombergNEF analyst Nikolas Soulopoulos. “And the economics work, or at least they’re starting to.”

The sweet spot for electric driving, it turns out, probably isn’t the passenger car, at least not yet. While batteries increasingly have sufficient range for road trips, recharging still takes much longer than filling the tank. And big 18-wheelers are too heavy and spend too many hours on the road to work with today’s EV technology. But for the middle ground—delivery vans, small buses and the like—those factors aren’t nearly as important. By 2030, BloombergNEF estimates, 15% of medium-duty trucks sold globally will be electric, more than 250,000 a year.

The routes they ply are often predictable, relatively short and full of stops—which can repeatedly top up the battery, thanks to regenerative braking (and save owners money on brake pads). And their schedules tend to allow ample time for overnight charging. “We are getting close to a day where the savings is so obvious, it will be irresponsible to buy an internal combustion vehicle,” says Giordano Sordoni, chief operating officer of Xos Inc., a Los Angeles electric-truck manufacturer that expects sales this year to double to almost 600 vehicles.

In April, e-truck makers got a sweetener for their sales pitch: up to $40,000 in tax breaks per vehicle, thanks to the recent Inflation Reduction Act. And state aid can be stacked on top of the federal money, so in generous California, a medium-duty truck might be eligible for as much as $120,000 in incentives. School buses can tap into an even richer vein of support, with some buyers scrounging up enough subsidy money to offset the entire cost of the vehicle, says Tim Reeser, chief executive officer of Lightning eMotors, an e-truck maker in Loveland, Colorado. “They’re essentially getting a free bus,” he says.

Medium-duty commercial vehicle sales outlook



E-truck makers typically start with a standard chassis from the likes of Ford Motor Co. or General Motors Co. Although those automakers are rolling out their own e-trucks, their transition has been slow, in part because such rigs are often less profitable than diesel versions. That leaves plenty of room for the upstarts, who fit the chassis with electric motors, battery packs and software. What goes on top—a bus, a big box for packages or a giant refrigerator—is up to the customer.

Xos, for instance, has built about 30 trucks for Loomis Armored US LLC, a Swedish company that ferries cash between businesses and banks, and it just got an order for another 150. Although the Loomis routes rarely exceed 100 miles a day, Xos adds extra battery capacity to compensate for the weight of bulletproofing and powerful air conditioners to keep guards in body armor comfortable. And Motiv Power Systems Inc., a manufacturer in the San Francisco Bay Area, is releasing a model that can draw power from its giant battery for auxiliary uses such as refrigerating the box or powering a hydraulic lift to trim trees or fix power lines.

From a climate perspective, it makes sense to clean up the trucks, which account for just 5% of vehicles on US roads but are responsible for an outsize share of emissions. Together with heavy-duty rigs, they spew more than a quarter of the country’s transport-created greenhouse gases, about triple what aircraft do, according to the Environmental Protection Agency.

Many companies that own them have drawn up ambitious timelines to make their fleets greener, either to burnish their environmental credentials or meet state requirements. Since the typical life span of a truck is 10 years, companies anticipating regulations that kick in a decade from now must start electrifying their fleets today, says Tim Krauskopf, CEO of Motiv, which has about 180 trucks on the road after 14 years in business and expects to build that many this year alone. “If you calculate back,” he says, “from any of these goals—say 50% zero-emission trucks by 2027—well, you better be buying now.” —*Kyle Stock*

THE BOTTOM LINE Trucks are eligible for up to $40,000 in federal subsidies. With extra state support, incentives can top $100,000.

PHOTO ILLUSTRATIONS BY LISETT LEDON FERNANDEZ, PHOTOS: GETTY IMAGES (3). *EXCLUDES REGULATORY CREDITS. DATA: BLOOMBERGNEF, TESLA, JATO, MOTOR1

Strategy

Is Tesla Disruptive or Defensive?

Tesla Inc. Chief Executive Officer Elon Musk has repeatedly slashed prices of the company's electric vehicles this year. Depending on whom you ask, the markdowns are either acts of desperation or necessary steps toward Tesla winning the automotive industry shakeout it started. Is Musk following a plan to convert as many consumers to EVs as quickly as he can, or has he bitten off more than he can chew? ——*Craig Trudell*

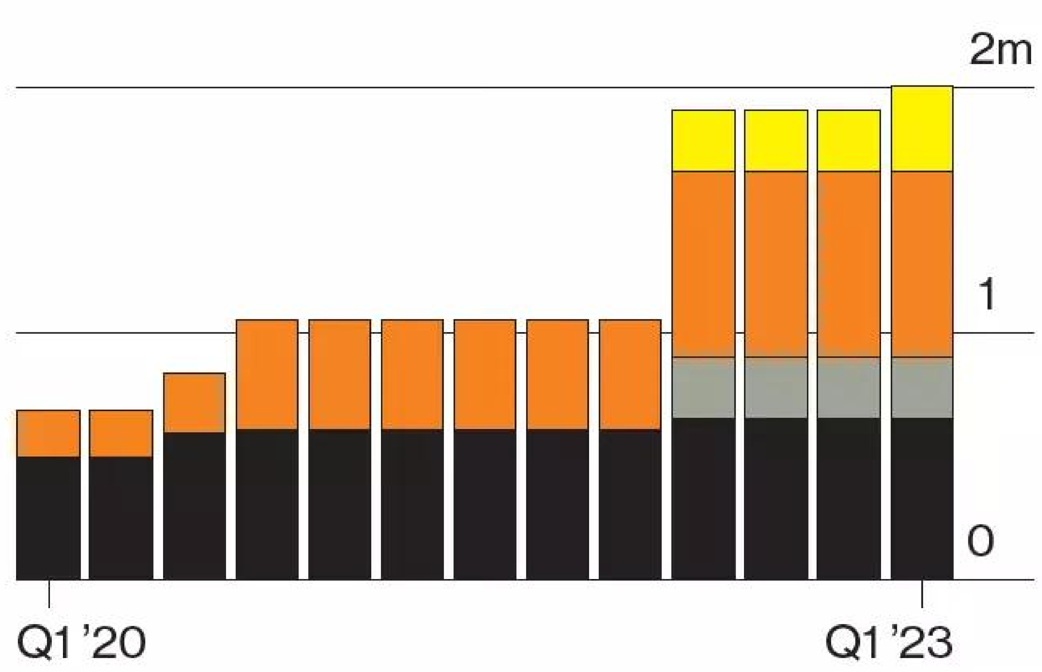
The Debate

DISRUPTIVE ELON

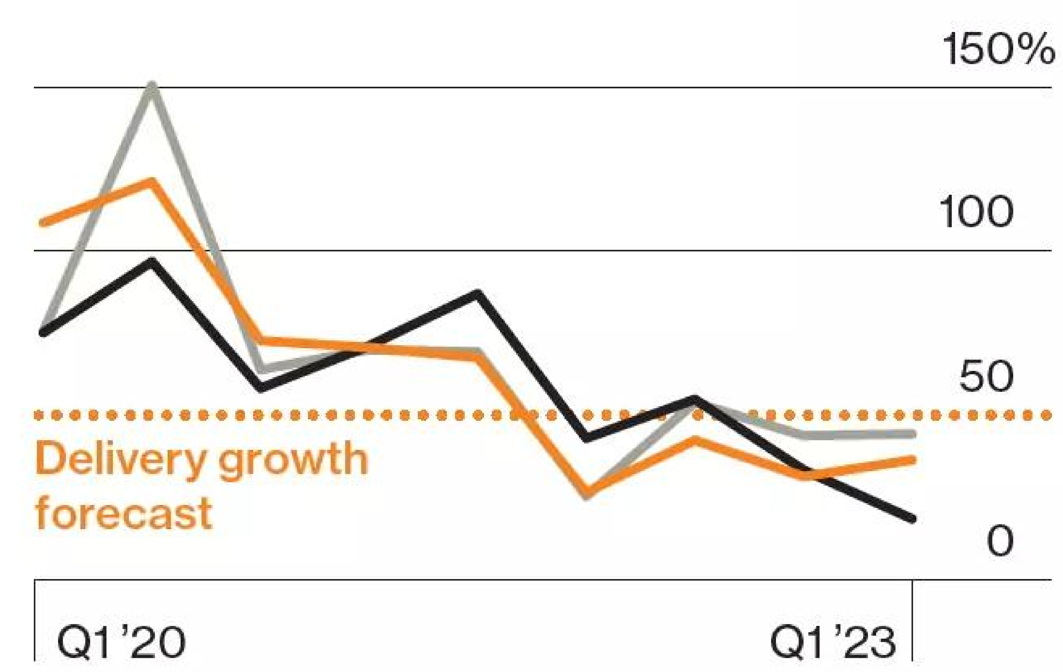
DEFENSIVE ELON

❶ Tesla opened its Shanghai factory at an ideal time: The Model 3 was still relatively new, and the Model Y was just rolling out. Adding plants in Germany and Texas last year boosted capacity, but vehicle sales haven't been growing as quickly as Musk expected.

Plant capacity

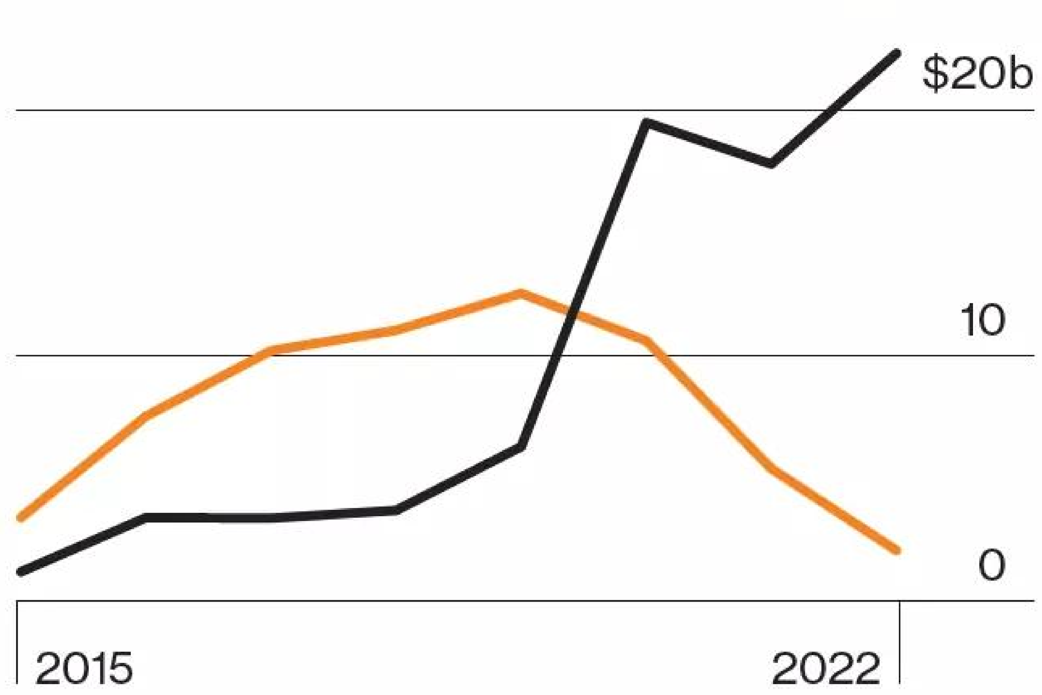


Year-over-year change in key metrics

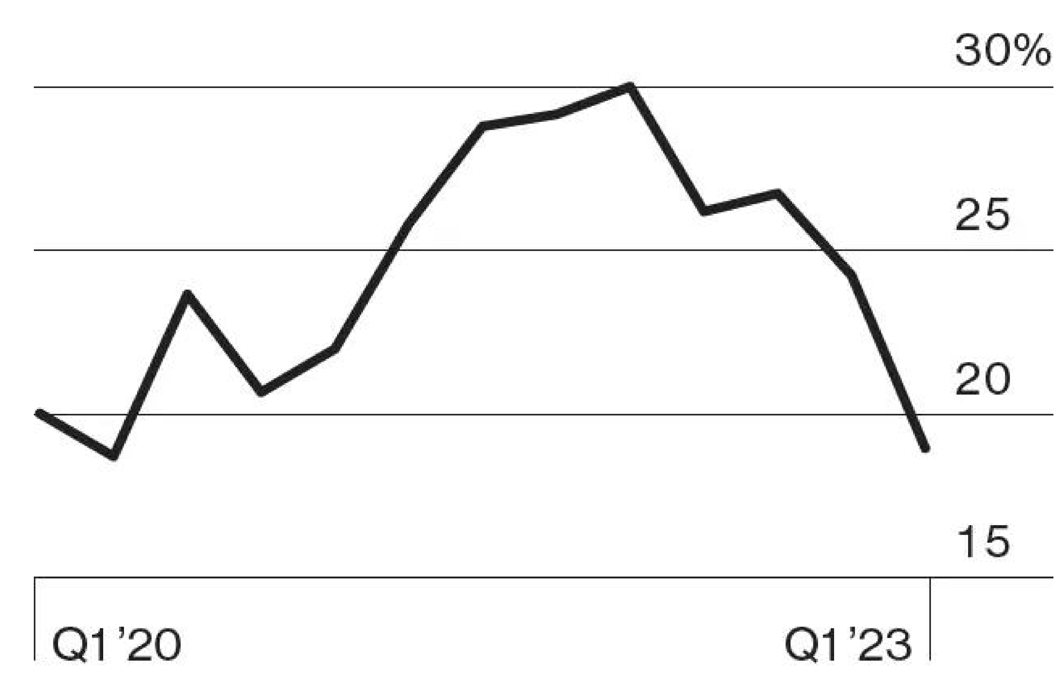


❷ The price cuts have shrunk Tesla's automotive gross margin to the lowest in almost three years. Still, the company may be able to sell cars at "zero profit," as Musk says he's willing to do, because it has built a substantial cash pile and paid off about $10 billion of debt over the past few years.

Cash cushion

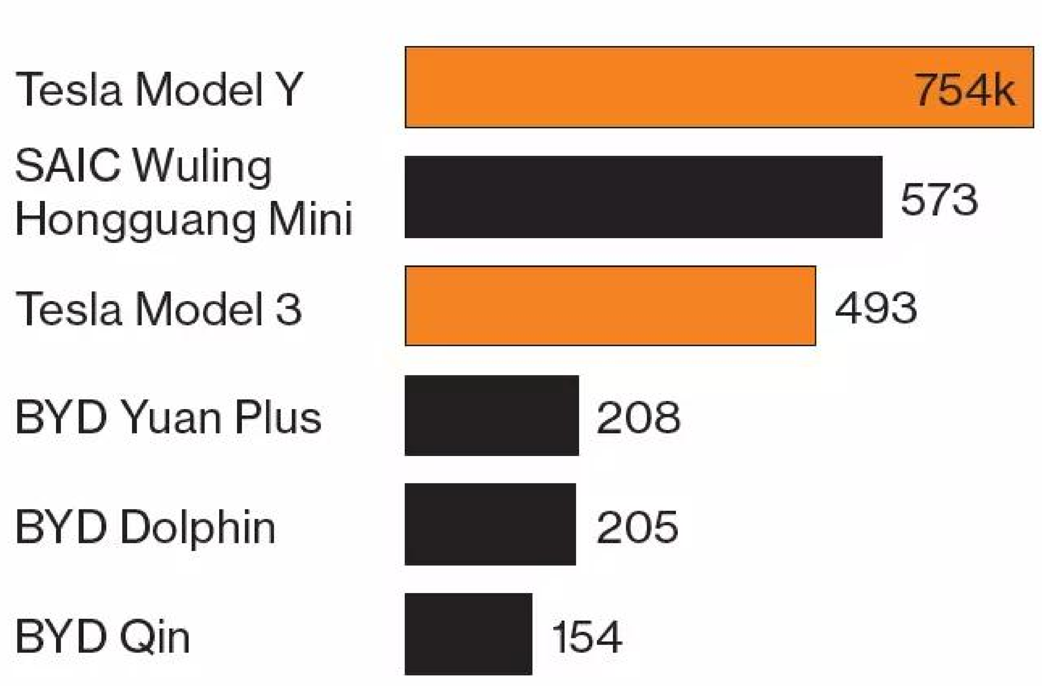


Automotive gross profit margin*

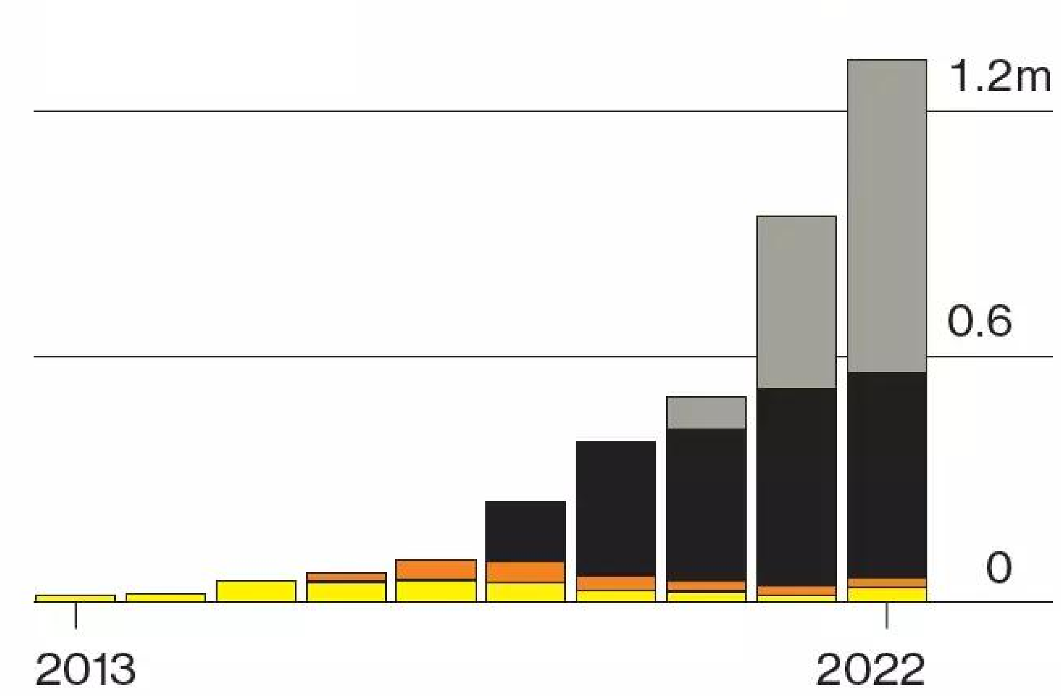


❸ Tesla benefits from economies of scale by manufacturing two of the highest-volume EVs. But Musk can't afford to let the Model 3 and Model Y age the way the Model S and Model X have. Sales for the latter two have languished because of minimal updates since their respective launches in 2012 and 2015.

Top-selling EVs, 2022 sales volume



Annual sales of Tesla models



weight loss drugs have a cost problem

Those ubiquitously marketed new meds? They work. And they cost at least $10,000 a year

BY EMMA COURT AND ROBERT LANGRETH

You've seen them on TV ads and TikTok, or heard them joked about at the Oscars: Ozempic, Wegovy, Mounjaro. They're weekly injections known as GLP-1 receptor agonists that help people lose a significant chunk of their body weight. These drugs can indeed produce dramatic results. But do they make people healthier?

Some people, yes. Others…the question is trickier than it sounds, and at least $100 billion a year is potentially riding on the answer. In the US alone, about 130 million adults are eligible for GLP-1s because of their weight and other health conditions. If just a third of Americans with severe obesity took them, US sales of weight loss drugs would swell more than 30 times, into an $80 billion industry, according to data analytics company Airfinity Ltd. Analysts at Jefferies Financial Group Inc. predict that GLP-1s for diabetes and obesity could become the biggest blockbusters of all time, bringing in as much as $150 billion a year globally.

But as of yet, most eligible people can't get them, because they're prohibitively expensive. In the US they cost upwards of $10,000 a year, potentially for the rest of someone's life. (The drugs essentially work as appetite suppressants, and if people stop taking them, they may gain much of the weight back.)

Private and public insurers aren't convinced they're worth covering. Medicare, the federal health insurance program for the elderly and some people on long-term disability, puts weight loss in the same category as balding and erectile dysfunction. Three-quarters of private insurers don't cover weight loss drugs, either. Most state Medicaid programs for low-income and disabled Americans restrict coverage, too, with just 10 offering broad coverage, according to a *Bloomberg Businessweek* survey of programs in all 50 states and DC. Coverage is also spotty in much of Europe and Canada. When insurers do pay, patients can face restrictions for how long they can take it or have to prove that they tried other weight loss methods first.

There's no doubt that, particularly at the extreme end, obesity is closely tied to a host of chronic health conditions. Doctors frequently recommend even modest weight loss to avoid obesity-related risks—high blood pressure, cholesterol, blood sugar. From the pharmaceutical industry's perspective, GLP-1s are a long-awaited solution to a growing and enduring public health crisis. Increasingly, doctors feel that way, too. "This is negligence and malpractice on the part of insurance companies," says Caroline Apovian, an obesity specialist who advises Ozempic and Wegovy maker Novo Nordisk A/S.

Insurance companies, no surprise, don't see things that way. They don't dispute that there are a lot of heavy Americans. The health risks they face as individuals, however, aren't so clear-cut. One recent review of medical studies found that up to a third of people with obesity are "metabolically healthy," meaning they don't have conditions such as diabetes and hypertension. Who even qualifies as ▶

ILLUSTRATION BY 731. PHOTO: WEGOVY

◀ obese is up for debate: The widely used body-mass index calculation doesn't accurately measure fat. "We need to be clear about which patients really do benefit from these medicines," Andrew Witty, UnitedHealth Group Inc.'s chief executive officer, said in April on a call with investors.

So far, trials have only proven that Ozempic lowers blood sugar levels and rates of heart attacks and strokes in people with type 2 diabetes. And insurers will mostly give people with diabetes, a group that includes some 35 million Americans, coverage for that drug. There's no proof yet that the drugs have long-term health benefits—beyond weight loss—for other people with obesity.

Novo and Eli Lilly & Co., which makes Mounjaro, are busy trying to prove they do. Both are testing whether GLP-1s prevent heart attacks and strokes in people without diabetes. Further trials are exploring other conditions associated with obesity, including heart failure, sleep apnea and knee osteoarthritis. "Our job is to change the assumption that obesity is not something you can manage medically," Lilly CEO David Ricks says.

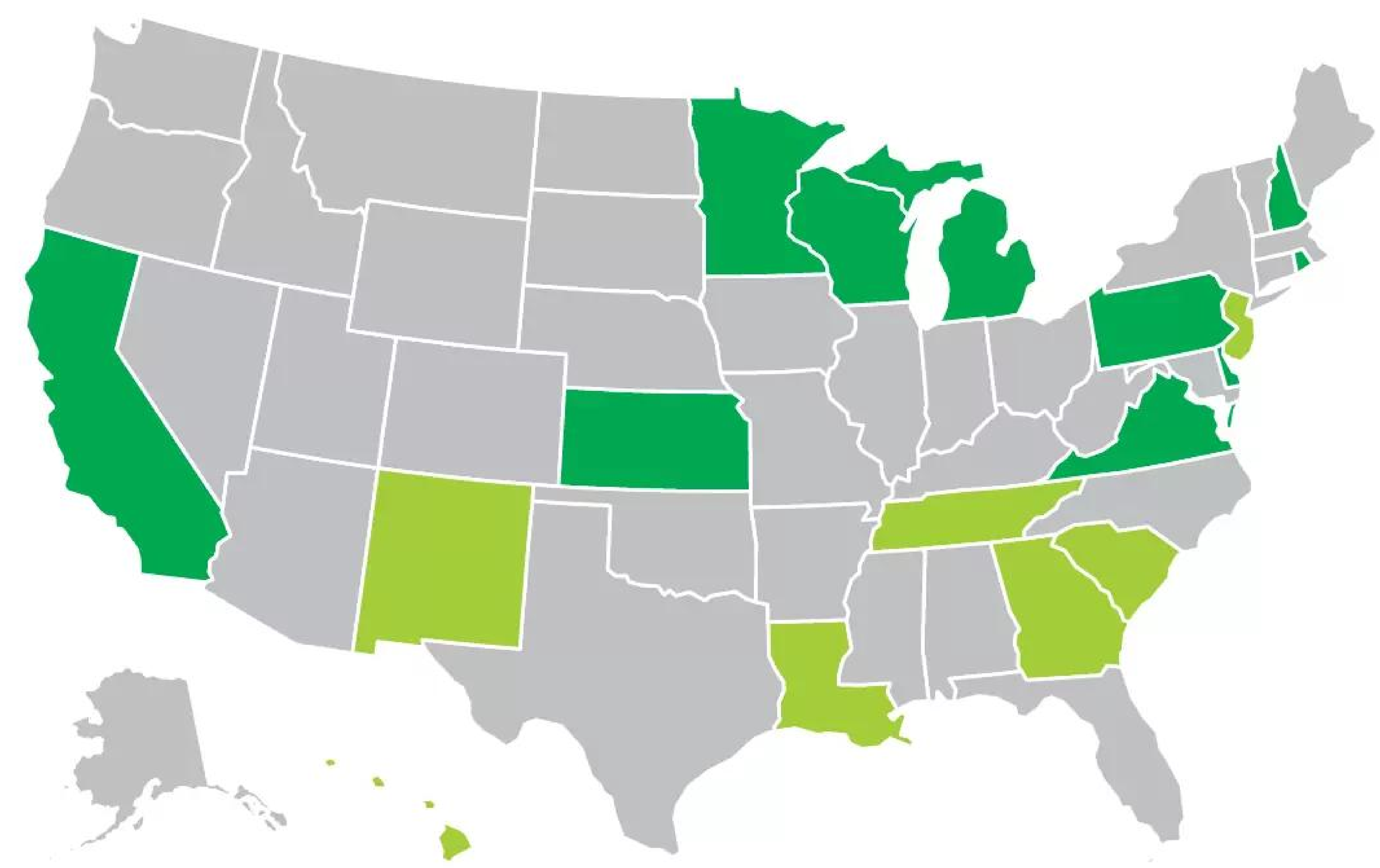
All of this is a familiar push-pull between pharmaceutical and insurance companies. Drugmakers always want more coverage; insurers resist. Even if just some people with obesity take a GLP-1, "the total cost could be overwhelming," says Jeff Levin-Scherz, a physician who leads population health for the consulting firm Willis Towers Watson Plc. The drugs' proponents argue they'd offer long-term savings. Studies have found adults with obesity account for $173 billion in extra medical costs in the US each year.

For now, patients are stuck in the middle. Sarah Bramblette, a 45-year-old with obesity who lives in Miami, lost nearly 70 pounds on Ozempic. Her insurance covered it as a treatment for insulin resistance. The weight loss also helped her qualify for a procedure to treat an irregular heart rhythm. When she needed to drop more weight for another surgery and to get a cancer screening, her doctor prescribed Wegovy, a stronger and more expensive treatment. Medicare wouldn't cover it. "We get blamed for being a financial burden on the health-care system," she says. "But then we don't get access to treatments that we would need to lessen that burden."

A decade ago, the American Medical Association voted to classify obesity as a disease. It did so to move the medical community away from treating weight as some sort of character flaw and toward something worthy of its care. The reclassification was also, in part, about economics: Insurers historically considered weight loss a cosmetic issue outside their purview; doctors wanted to encourage them to cover it as a health one, says Douglas Martin, who chaired the committee that brought the resolution to a vote. The promise of future reimbursements might encourage pharmaceutical companies to develop safe and effective drugs.

Up to that point, weight loss drugs had a bad track record. The fen-phen craze in the late 1990s imploded after one of its components was linked to heart valve damage. Over the next two decades, several other pills were recalled for safety reasons. "Obesity drug development was a graveyard," says Novo CEO Lars Fruergaard Jorgensen.

Medicaid Coverage of Obesity Drugs



DATA: BLOOMBERG SURVEY OF ONLINE PLAN DOCUMENTS AND COMMUNICATION WITH STATE OFFICIALS. CONNECTICUT'S MEDICAID PROGRAM PLANS TO START COVERING OBESITY DRUGS IN JULY. COVERAGE SHOWN AS OF APRIL 2023.

GLP-1s first came to market as a diabetes treatment, but initial trials in the early 2000s showed they could result in weight loss, too. The drugs mimic a gut hormone—glucagon-like peptide-1—that reduces people's appetites and makes them feel full. "We had lengthy discussions about whether we dared to go into development in the obesity indication," Jorgensen says. Drug companies decided to push ahead with the drugs just for diabetes, a more stable market. In 2005, the US Food and Drug Administration approved the first GLP-1 for diabetes, Byetta, followed by a Novo drug called Victoza in 2010.

At that point, the weight loss GLP-1s caused in clinical trials was so significant that Novo decided to test them as obesity meds. Five years later, Saxenda hit the US market. Saxenda, a daily shot that costs about $1,350 a month, can help people lose about 5% to 7% of their body weight. It often has unpleasant side effects, as other GLP-1s do, including nausea, diarrhea and vomiting. The medication also lists a potential risk of thyroid cancer. Saxenda wasn't very successful commercially, but it was effective and largely safe, which was enough to encourage more development from Novo and its competitors. Ozempic, Novo's weekly GLP-1 shot for diabetes, went on sale in 2018, followed in 2021 by Wegovy, a higher dose of the same medication developed specifically for obesity. Eli Lilly's Mounjaro, approved for diabetes last year, has shown even more dramatic slimming results, with patients on the high dose losing around 50 pounds in a big trial published last year. Lilly is filing for approval to treat obesity.

The drug companies, it turned out, didn't need the promise of insurance coverage to create a market for these treatments. Americans spend about $50 billion a year trying to shed pounds. (We didn't evolve to sit in offices and eat highly processed carbs all day, but here we are.) Drugs that seem to offer quick, straightforward results are particularly appealing. Four million people took fen-phen in the few years the

“If the drugs cost $10, we wouldn’t be having this discussion”

drug combination was popular. Novo, which sold nearly $900 million worth of Wegovy last year, has roughly doubled its market value since launching the drug in mid-2021—making it more valuable than Pfizer Inc.

One uncomfortable truth, though, is that at least some of that demand is driven not by a medical need but a desire to be thin that’s not necessarily healthy. Celebrities, including Elon Musk and comedian Chelsea Handler, have said they’ve taken the drugs; there are rumors of “Ozempic parties” in Hollywood.

Insurers, reasonably, don’t want to support that kind of use. But another uncomfortable truth is that it can be hard to tell when a person’s need is cosmetic, medical or both.

At more than $10,000 a year, GLP-1 drugs are some of the most expensive type-2 diabetes treatments on the US market. Wegovy, which has approval as an obesity treatment, goes for more than $17,000 a year—40% more than Ozempic, which is the same drug in a smaller dose. (Asked about the high pricing for Wegovy, Jorgensen says “it’s a more efficacious product.”)

Even if only 10% of Medicare beneficiaries with obesity take Wegovy, it could cost around $27 billion a year, or about 18.5% of Medicare’s net drug spending, according to an analysis recently published in the *New England Journal of Medicine*. “If the drugs cost $10, we wouldn’t be having this discussion,” says Angela Fitch, an obesity doctor in Massachusetts and president of the Obesity Medicine Association.

GLP-1 drugs aren’t costly to make. Wegovy could be sold for just $40 a month, according to a February study in *Obesity* that analyzed prices of raw chemical ingredients. In the UK, where drugs are generally cheaper, Ozempic costs about $90 a month. Andrew Hill, a study co-author at the University of Liverpool, says high prices will keep these medications from people in Africa, India and other lower-income countries where obesity rates are on the rise.

“We’re going to be looking for the very best pricing on these medicines,” UnitedHealth Group’s Witty said on the April call with investors. “Still plenty to come here, I think. Early days.”

Daniel Drucker, a co-discoverer of the GLP-1 hormone who works as a professor of medicine at the University of Toronto, says he’s asked companies he consults for why they don’t make their medicines more affordable. “When they run the models, they make more money selling fewer units for higher costs,” he says.

Pharmaceutical companies, as ever, need new moneymakers. Pfizer’s stock has fallen this year as demand for Covid-19 vaccines and treatments has waned. In January, CEO Albert Bourla predicted the GLP-1 pills it’s developing could bring more than $10 billion in annual sales. Novo and Lilly are both seeking replacements for the designer insulins that make up billions of their sales now that US lawmakers have pressured them to slash prices.

Lilly and Novo declined to comment about Drucker’s remarks. They said their prices reflect their products’ efficacy and medical value. Drug companies, of course, charge as much as possible for as long as possible. They also provide coupons to shield patients with private insurance from high out-of-pocket costs, while getting insurers to foot much of the bill.

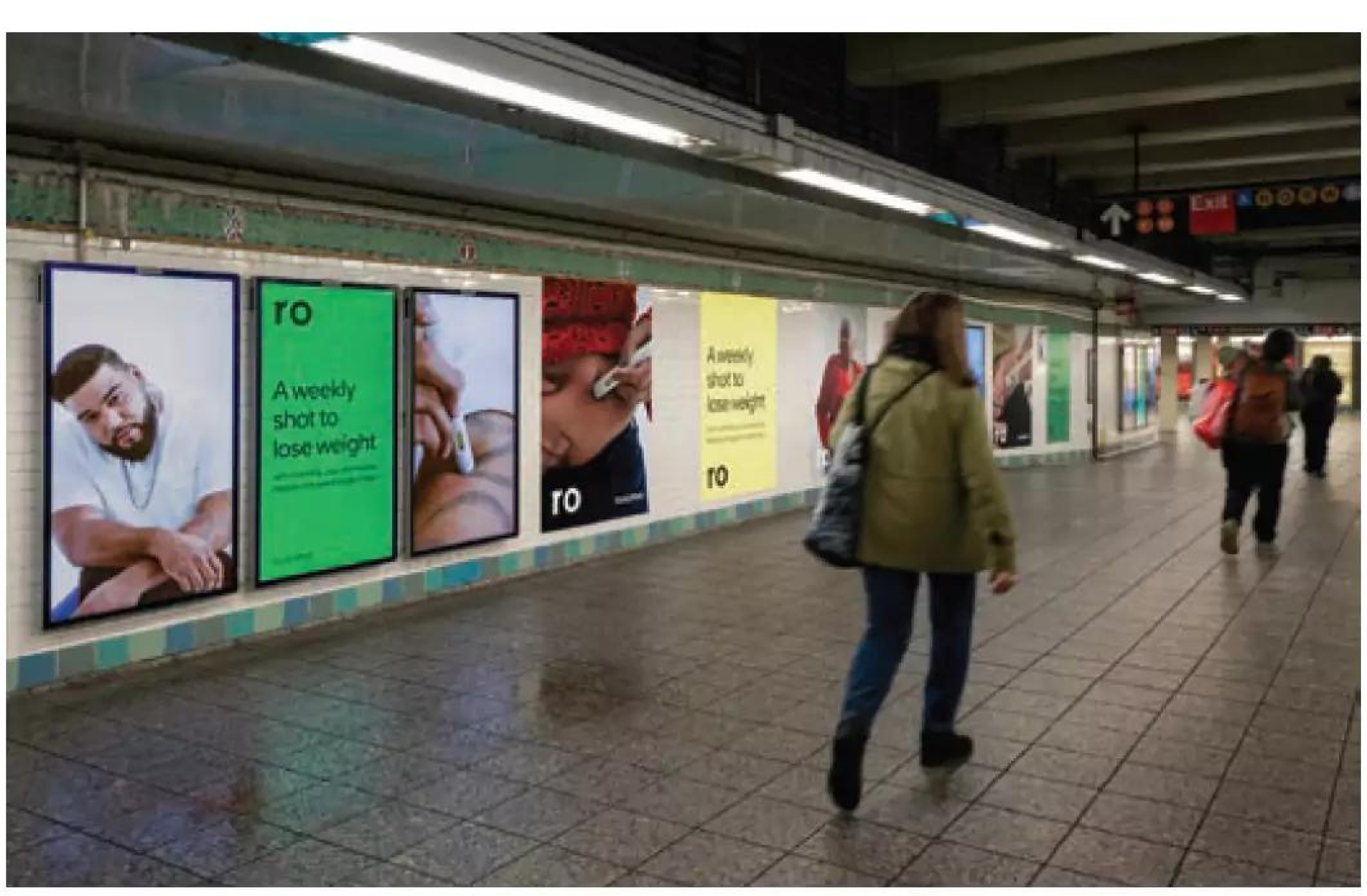
The government could make insurers budge. Accordingly, Novo has increased its lobbying spending in the US by nearly 80% since it launched its first obesity drug. It also funds research on the costs of obesity and works with doctors who prescribe the drugs.

This year, the Office of Personnel Management started requiring insurers in the sprawling federal employee health plan—which covers 8 million people—to include at least one GLP-1 obesity drug. *Bloomberg Businessweek*’s survey of Medicaid plans found four states have added obesity drug coverage since 2021: Michigan, Minnesota, Pennsylvania and, starting in July, Connecticut. Eight more have said they’re considering adding coverage.

Novo Nordisk has also lobbied Congress to pass the Treat and Reduce Obesity Act, which would expand Medicare coverage to include obesity drugs. There are an estimated 20 million Americans with obesity on Medicare. The Centers for Medicare and Medicaid Services is also now considering updating the Affordable Care Act’s requirements about which basic benefits health insurers have to cover. The AMA is pushing to have obesity drugs included; Cigna Group is opposing this change.

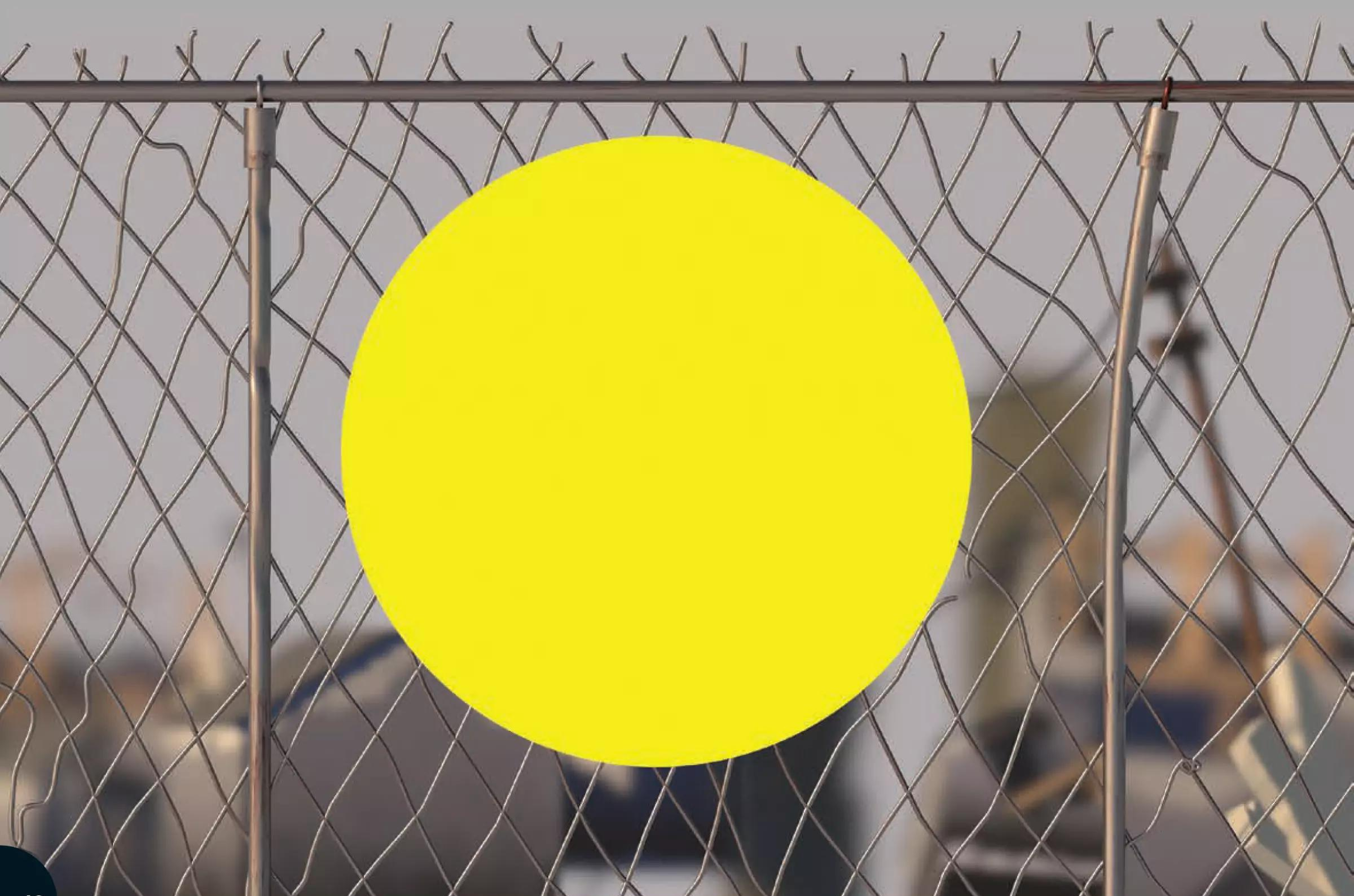
While insurance and pharmaceutical companies battle it out, Americans are going to great lengths to pay for the drugs. When Lisa Carannante first got on Wegovy, her insurance covered it. About six months and 60 pounds later, Blue Cross and Blue Shield of North Carolina suddenly dropped the drug from Carannante’s plan. (The insurer told *Bloomberg Businessweek* it did so to “align with current market offerings.”)

Carannante had worked with her husband at their restaurant in Burlington, North Carolina, while raising their eight children. To get Wegovy coverage, last November she took on an overnight shift at a hospital as a nursing assistant. She found the hours too grueling to manage with child-care duties, and in April she switched to a job with better hours. She thinks her new insurance plan covers Wegovy but isn’t 100% sure. She’s stocked up on refills just in case. Ⓑ —*With Tanaz Meghjani*



COURTESY OF RO

New York subway ads for obesity drugs



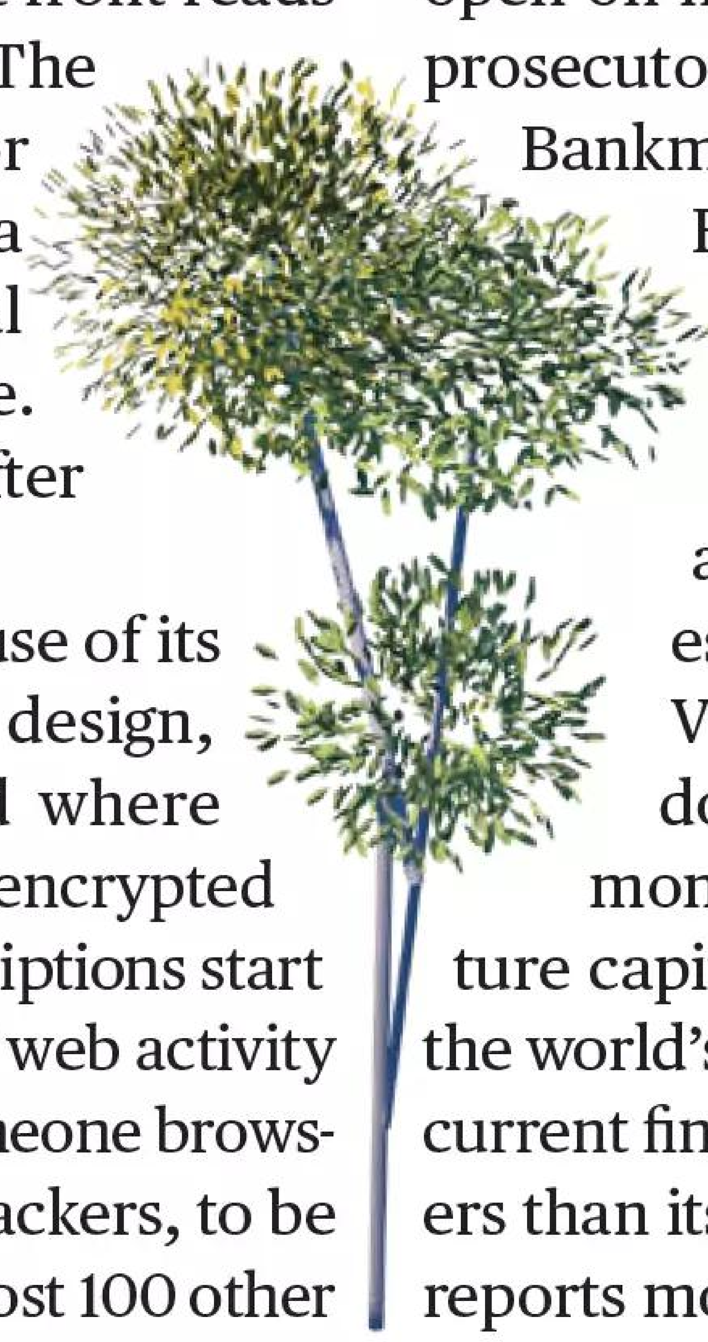
Big VPN's Trust Issues

Virtual private networks have become a cornerstone of personal security online. What are their makers really selling?

BY **AUSTIN CARR**
ILLUSTRATIONS BY **JON HAN**

PHOTOGRAPHS BY
FELIX VON DER OSTEN & KAYLA KAUFFMAN

At the former site of a Soviet-era sock factory in Vilnius, the old-world capital of Lithuania, NordSec BV's new headquarters is rising in a clatter of construction workers and scaffolding. Soon the startup's roughly 2,000 employees will gather near the remains of a brick smokestack for basketball and rooftop barbecues at a sleek complex that wouldn't look out of place in San Francisco. When co-founders Tom Okman and Eimantas Sabaliauskas invested in the factory property four years ago, it was still making hosiery. Now the sign at the bus stop out front reads *Vienaragiu*, the Lithuanian word for "unicorn." The Silicon Valley-style conspicuousness is new for Okman and Sabaliauskas, who spent close to a decade developing NordSec and its principal brand, Nord Security, while keeping a low profile. It's also a little unusual for a company that is, after all, in the privacy business.

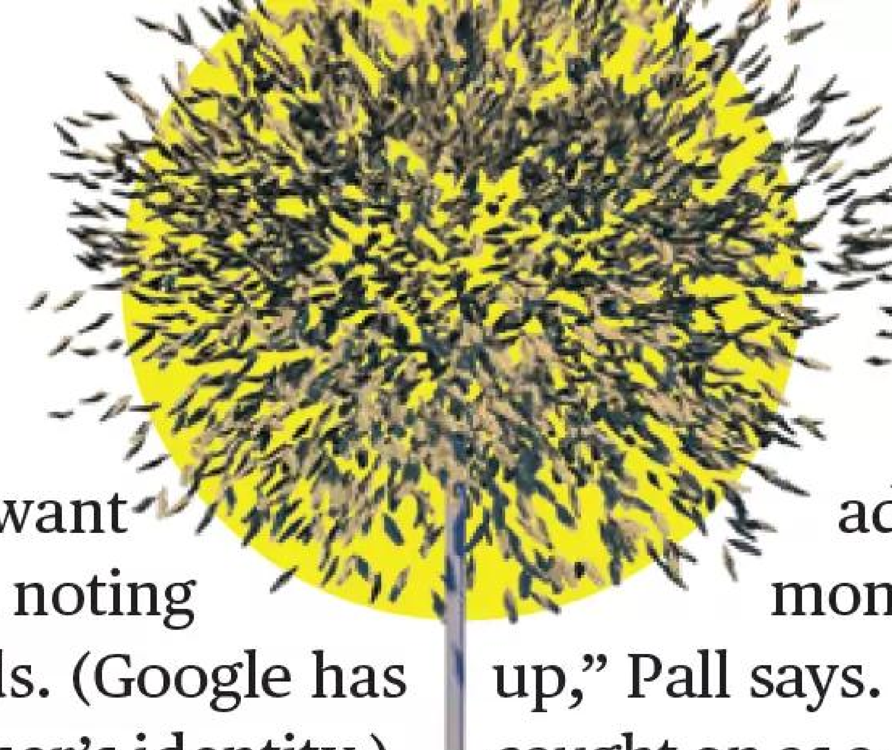


If you've heard of Nord, that's probably because of its virtual private network software, NordVPN. By design, VPNs hide what you're looking at online, and where you're looking from, by routing traffic through an encrypted "tunnel" to other servers around the world. Subscriptions start at $3.29 a month, and NordVPN's app filters users' web activity through roughly 5,500 servers in 60 countries. Someone browsing in Vilnius might appear, to websites and ad trackers, to be sitting in Miami, Osaka, São Paulo or any of the almost 100 other cities where the company keeps hardware. Depending on whom you ask, VPNs offer much-needed privacy and freedom from snooping corporations and governments, or simply a way to stream Netflix or ESPN+ in places where they're blacked out.

Even some common uses for VPNs are legally dubious, so the companies that run them have traditionally maintained complex, variably sketchy data policies and chains of ownership. The industry's leaders, however, are no longer shying away from the public eye. When I sit down with Okman, Nord's co-chief executive officer, at a steakhouse near the old sock factory in November, he's just returned from speaking at Web Summit, the big tech conference in Lisbon, and is preparing for his second trip to the annual World Economic Forum in Davos, Switzerland. A few years ago, the Davos crowd didn't know what a VPN was. "Now everyone does," Okman says.

The week we met, *Time* named NordVPN one of the best inventions of 2022, describing it as an essential security tool. Instagram posts from the musician Drake have shown NordVPN open on his MacBook while he gambles online, and federal prosecutors recently caught disgraced FTX co-founder Sam Bankman-Fried using a VPN while on bail. (A lawyer for Bankman-Fried, who's been charged with fraud and is prohibited from using certain encrypted software, said he was using it to watch the Super Bowl at his parents' house.) According to Top10VPN.com, a review site that tracks industry data, Russian interest in VPNs rose by more than 1,000% after President Vladimir Putin invaded Ukraine last year and blocked domestic access to Facebook and Twitter. About a month later, Nord Security raised $100 million in venture capital at a $1.6 billion valuation, ostensibly making it the world's most valuable VPN startup. Nord won't disclose its current financials, but Okman says it has more active subscribers than its closest competitor, Kape Technologies Plc, which reports more than 7 million paying customers and has a market value of $1.5 billion.

Along with Kape's ExpressVPN, Nord has become the face of a market that's been trying to go mainstream and distance itself from geekier or less reputable competitors with names like Faceless.me, Hotspot Shield and HideMyAss. So far, Nord and Kape have been able to keep growing despite fresh competition from companies with far deeper pockets, including Apple Inc., which offers a VPN variant called Private Relay, and Google, which integrated its own VPN into its Pixel ▶



◀ smartphones last fall. “I’m not sure you’d want to use a Google VPN for privacy,” Okman says, noting the search giant’s dependence on targeted ads. (Google has said its VPN can’t link network traffic with a user’s identity.)

Some researchers warn that no VPN should be seen as a guarantee of privacy. Roya Ensafi, an assistant professor of computer science at the University of Michigan who studies the field, says she and her colleagues have found that VPN makers oversell how much security they provide. An internet service provider, let alone the Pentagon or Putin, can figure out who’s using a VPN based on internet patterns or traffic leaks. In some cases, it’s possible for a malicious ISP or state to temporarily interrupt a VPN connection and expose sensitive personal information while its encrypted tunnel is closed off. “Almost every obfuscation implemented for VPNs that we studied is embarrassingly ineffective,” Ensafi says. Some VPNs have also been caught harvesting user data for market research, hiding ties to China or storing traffic logs. In 2017 the *Wall Street Journal* reported that Onavo Protect, a free VPN run by Facebook Inc., was monitoring how often users accessed competing social media services. (Facebook, which said it was clear about what information it was collecting, shuttered Onavo 18 months later.)

Okman says that PwC has audited its no-logs policy and that having an extra layer of encryption is better than the alternative. “If you want to be secure online, you have to use a VPN,” he says. Nord has protections against traffic leaks and has developed companion software, including a password manager, an encrypted cloud storage service and a malware scanner. When asked about legally gray uses for VPNs, Okman mostly acts shocked, shocked to find that gambling—or illicit streaming and the like—is going on in here. He’s aware of bad actors in the industry but insists that Nord is operating aboveboard. “We’ve never been hiding in the Cayman Islands or anywhere,” Okman says. (A Nord spokesperson says NordVPN is registered in Panama because that country’s laws don’t require companies to retain user data.)

As Nord expands, it’s facing pushback from states peeved about VPNs enabling access to restricted media, as well as from content providers trying to stop overseas binge-watching of US-only streaming services such as Hulu LLC. But perhaps its biggest challenge will be convincing average customers that VPNs are safe and necessary. Jack Wilson, who researched VPN vulnerabilities at Scotland’s Abertay University, says all a VPN really does is “transfer trust” over your browsing from an ISP to a far-flung startup with nebulous oversight. “It boils down to: Who do you trust more?” Wilson says.

The first VPNs emerged in the 1990s as a way for corporate employees to work from home. Microsoft Corp.’s product-incubation head Gurdeep Pall, who was part of a team credited with creating an early VPN for Windows 95, recalls the idea of remote logins to an office network being so novel that he struggled to find more than a dozen early adopters for a dial-up precursor. “The first few months, only like 13 of the 16 modems would light up,” Pall says. As broadband replaced dial-up, though, VPNs caught on as a security measure among tech companies, banks and hospitals.

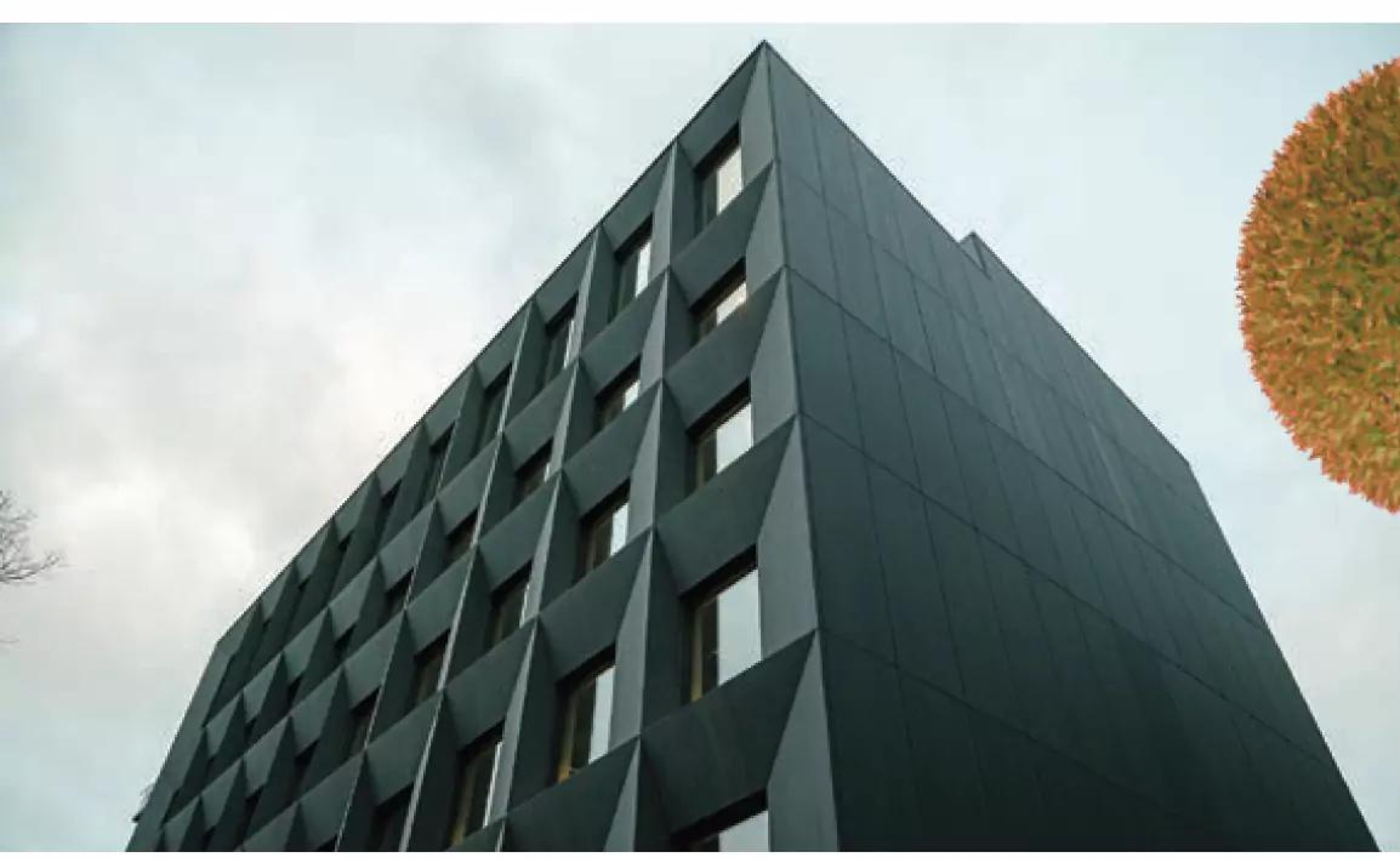
A parallel VPN ecosystem blossomed around hackers seeking entertainment. Jovan Petrovic, employee No. 1 at HideMyAss, which grew popular in the late aughts and featured a logo of a donkey dressed as a secret agent, says it became “a game of hide-and-seek” with governments and companies like Netflix Inc. to enable access to georestricted websites as they blocked the generic IP addresses VPNs give users to shield activity. He clarifies that VPNs were never some holy product. “It’s all about torrenting, streaming and, you know, porn,” he says, laughing.

It was around this time that Okman and Sabaliauskas first encountered VPNs. They were born during Lithuania’s final years under Soviet occupation and fell in love with the computers that soon arrived from the West. They met in a chatroom circa 1999 and spent years bonding over the finer points of system networking. They met in person once Sabaliauskas went to study information technologies at university in Vilnius, Okman’s hometown, in 2002. After graduating, Sabaliauskas joined a marketing company focused on web ads and search engine optimization, while Okman worked for one of Lithuania’s biggest ISPs. “He was basically taking cables to people’s homes and connecting them to the internet,” Sabaliauskas says.

The pair were constantly dreaming up business ventures and even established a startup incubator called Tesonet, though it didn’t incubate much until 2012, when they created what would become NordVPN. They’d been using corporate VPNs at work and thought they could build something superior. Renting servers for about $50 a month in Germany, they hacked together a basic system with an open-source VPN protocol, followed by rudimentary PC and Mac programs. For the first couple of years, at least, customers had to know a lot about network configurations. “It was a mess,” says former product manager Justinas Jakunas, who joined in 2014. “It was too geeky. But people were still using it.” Instead of raising money from venture firms, Nord charged its few thousand users around $8 a month (or less) and slowly expanded its staff and server base. Okman was obsessed with speed and reliability, so the company’s engineers tried to keep enough servers on hand to ensure that none was ever using more than 30% of its bandwidth.

In 2015, Nord topped 10,000 customers and added an iPhone app, followed by an Android counterpart the next year. The mobile interface was much more intuitive, with a map of Nord’s roughly 500 servers and a one-click button that connected users to whichever one was currently fastest. Nord and other VPN startups benefited from customers’ growing fears about data mining. One industry accelerant was the Trump administration. In 2017 the White House overturned a rule that would have required ISPs to ask for consent to share or sell customers’ browsing histories for marketing purposes.

Okman and Sabaliauskas are building a Silicon Valley-style campus at the site of a Soviet-era sock factory

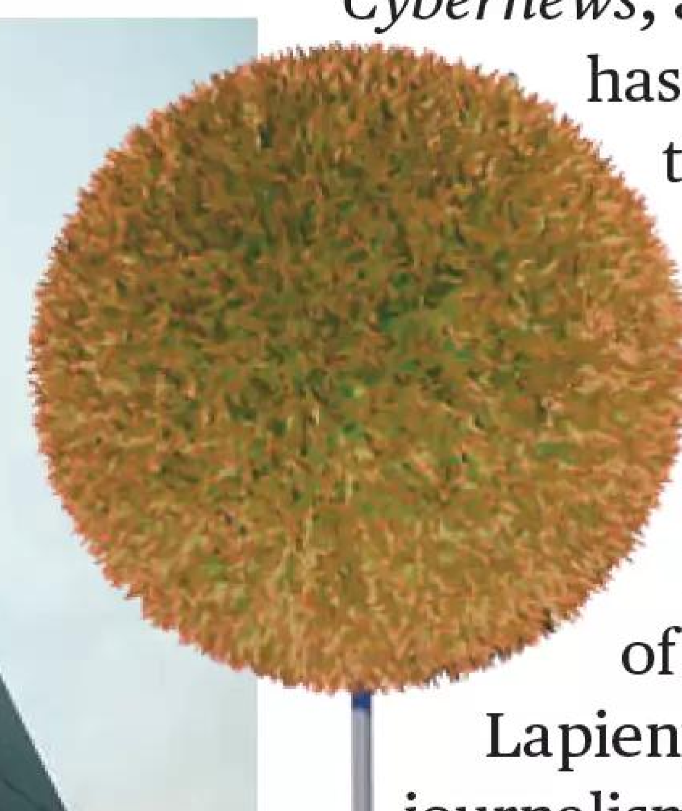


Sabaliauskas says Nord's US user base nearly quadrupled soon afterward: "We put up a photo of Donald Trump as our employee of the month."

As it gained market share, Nord added more clever privacy features, including an encryption system that routes traffic through two servers instead of one. But its competition with ExpressVPN has largely been an old-fashioned marketing fight, albeit one that Okman says involves some 15,000 YouTube influencers. Kazimieras Celiesius, a former Nord developer, says the company's ad campaigns for years were aimed at customers with little to no technical expertise. "I call it the grandma segment," Celiesius says. "Grandma saw it on TV, she bought it, and she doesn't even know how to turn it on." Some ads promised "military-grade encryption" and said "your data will never be compromised with NordVPN"—promises a Consumer Reports study found misleading. Darius Skuncikas, a former user-retention leader at Nord, says a common subject in meetings was how to ensure customer access to streaming services over its VPN. "If we saw huge cancellations, the first question was 'Does Netflix work?' " he recalls. A NordVPN spokesperson says that it uses an encryption standard approved by the US National Security Agency and that the aim of its marketing is to communicate technical features to everyday consumers with easy-to-understand words.

VPN makers have also won customer trust through deals with affiliate marketers, including VPN-ranking sites. Many of these sites, which receive referral fees for VPN subscriptions purchased through their links, have said their editorial decisions are free from commercial pressures. "We got emails from these reviewers saying, 'Hi, guys, No. 5 spot is now for sale if you give us a certain amount of money,' " says Jan Jonsson, the CEO of Mullvad VPN AB, a Nord competitor. Simon Migliano, the research head for Top10VPN.com—which asserts that it's independently owned and that referral commissions don't affect its reviews—says some ranking services are quietly owned by the VPN brands themselves. He calls that "a massive credibility problem."

Celiesius suggests it's an open secret in the industry that *Cybernews*, a top VPN review site on Google's search results, has ties to Okman and Sabaliauskas's Tesonet incubator. *Cybernews* ranks NordVPN and two other VPNs in Tesonet's portfolio, Surfshark and Atlas, as the industry's best three services. A Nord spokesperson acknowledges that Tesonet has worked closely for years with *Cybernews*'s owner, Adtech LT UAB, and invested in a new umbrella company of the site in October. *Cybernews* chief editor Jurgita Lapienyte says her team "adheres to core principles of journalism" and that their analysis is "in no way influenced by the company's business goals."



It's impossible for customers to figure out which VPNs to trust. They can't visit a data center to check that a provider's servers are properly safeguarded, nor can they inspect Nord's code to make sure it's keeping their web traffic hidden. In 2019 reports surfaced that Nord infrastructure at a Finnish data center had been compromised the previous year, sparking headlines about a potential breach of web traffic logs—data on subscribers that Nord says it doesn't collect. Okman dismisses those reports as conspiracy theories, stressing that the incident affected only one server out of thousands and that his company later removed all hard drives from its servers to ensure that it physically could not log customers' traffic. "For us, it would be super f---ing stupid to collect logs," he says.

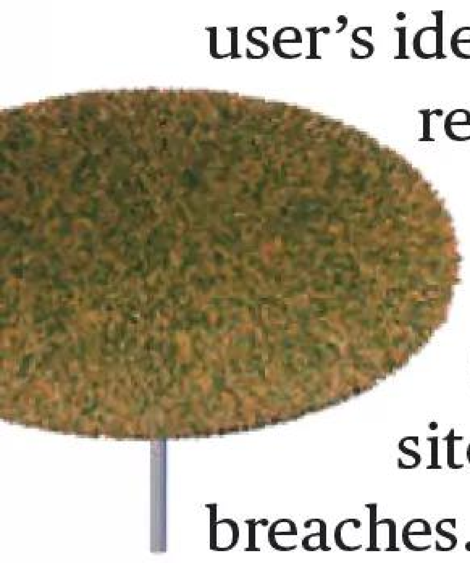
In September 2021, UK-based Kape, which had already bought VPN brands including CyberGhost and Private Internet Access, agreed to acquire ExpressVPN for $936 million. This should have been a sign of the industry's growth, but instead ▶

◀ it raised more questions about its legitimacy. Before 2016, when Kape was called Crossrider, its products enabled other developers to inject ads into users' PCs. It could only ask customers to trust that it had changed. "Kape has moved on from those times," says ExpressVPN Vice President Harold Li.

Nord's first web server in Germany

Okman starts his day before dawn, running through Vilnius's cobblestone streets. He usually logs around 60 miles a week, training for Ironman competitions and, lately, a marathon at the North Pole. He's equally single-minded at the office, where he's prone to firing off Slack messages a word at a time, flooding employees' phones with notifications. The team's current priority is persuading customers to keep its VPN running 24/7. The more the customers keep the VPN on, the more likely they are to renew their $4 or so monthly subscriptions, which Okman says can turn an 80% profit. Users log off Nord for a variety of reasons, whether because server speeds slow down or because they've concluded that their web surfing simply doesn't need VPN protection.

Rising industry scrutiny is teaching VPN users that they aren't immune to phishing attacks or other scams. If you're logged into Gmail, Google can monitor your activity even with an anonymized IP address. Nord keeps your email address and billing info on file, and there are ways of triangulating a user's identity. "Device fingerprinting," for example, cross-references metadata such as the size of your screen and the version of Chrome you're using.



NordVPN's app now features a malware scanner and dark-web monitor to guard against suspicious sites and downloads and to track exposures in data breaches. Nord has also introduced NordPass, a subscription password manager, plus an $8-a-month encrypted cloud service. When I arrive at Okman's office, which he shares with Sabaliauskas and two fellow execs, they're whiteboarding code for NordLayer, an encrypted networking system designed to give mom and pop businesses a lower-cost version of the kind of expensive firewall protection Palo Alto Networks Inc. provides Fortune 500 companies.

Another new product is Incogni. Developed by Surfshark, a VPN Nord merged with in 2022, it automates the removal of personal data from hundreds of data brokers that operate inscrutably online. "If you try to do it yourself, it takes months," says Surfshark founder Vytautas Kaziukonis, sitting beneath a security camera in his office that he's tilted toward the wall for privacy. "We do the work for you."

While Nord is focused on diversifying its product lineup, VPN revenue represents the vast majority of its

"YOU CAN'T JUST GET A VPN AND BE SECURE WITH EVERYTHING. THAT'S WHY WE HAVE DIFFERENT PRODUCTS"

sales. When Okman shows me his smartphone app, I see his NordVPN subscription is active through September 2050. But unlike a decade ago, when accessing your bank account from a motel's Wi-Fi portal might've been risky, these days more banking websites and browsers offer encrypted connections by default.

The rest of the industry seems to be similarly incorporating VPNs into broader security packages. HideMyAss, which has rebranded as HMA, is now owned by the parent of anti-malware brands Avast and Norton. Google is marketing its VPN as a cybersecurity enhancement rather than a tool to bypass geographic web restrictions. Antivirus companies such as S.C. Bitdefender Srl and McAfee LLC offer their own VPNs. ExpressVPN's Li compares VPNs to an ADT-like monitoring hub that provides safety and peace of mind—but that doesn't free you from having to lock your doors. "A home security system might have an ad that says, 'Protect your home from intruders,' or 'Protect your valuables,'" Li says. "It doesn't have an asterisk that says, 'If there's a fire, your home security system is not going to save your valuables.'" Birgir Már Ragnarsson, managing partner at Novator Partners LLP, which led Nord's $100 million financing round in April 2022, says VPNs on their own are now a commodity: "You can't just get a VPN and be secure with everything. That's why we have different products."

But if there's one product Nord swears it's not selling, it's illicit access to streaming services. Okman tells me the company is not optimizing to evade Netflix blockages, and, in any case, he reminds me that Nord doesn't even know if its users are streaming stuff, because servers don't collect logs. He says that Nord has never received complaints from Netflix and that it tries to make such services function only so subscribers don't have to turn off VPNs when they're at home watching TV.

"The reality is 90% of our customers connect domestically," he says, meaning if they were avoiding geo-restrictions, they'd presumably connect to a server in a different country. (Netflix declined to comment.)

The explanation sounds a little funny, not least because the Peacocks and YouTube TVs of the world appear engaged in constant whack-a-mole with VPN IP addresses to prevent unauthorized streaming. VPN review sites and Reddit threads are full of tips on how to game the platforms. In the US, for one, it's easy to use a VPN to switch to servers in different states to sidestep regional blackouts on ESPN+ for hockey games. (An ESPN spokesperson says the company takes protecting intellectual property seriously and has technology to identify suspicious activity.) When I bump into Cyril Polac, NordVPN's country manager for France, the first insight he shares about the market is related to live sports: "Formula One, in France, will be broadcasted by a specific private

DATA: TOP10VPN 2020 REPORT

channel that will be extremely expensive, while you will find the same exact sport broadcasted for free in Belgium."

When I relay this to Okman, he's unfazed. "We're not denying that's a use case," he says. "It's just not our focus."

Over the past couple of years, Nord and other VPNs have been at loggerheads with Roskomnadzor, Russia's federal communications agency. "They asked to 'give us the encryption keys,' and we didn't," Okman recalls. Instead, the company terminated its contracts with local data centers and had its servers shredded in early 2019. Russians could still connect to NordVPN via non-Russian servers, but in September 2021, Roskomnadzor announced it was barring access to NordVPN, ExpressVPN and other services, implying they were contributing to the distribution of drugs and child pornography online. Russia's invasion of Ukraine commenced six months later.

A similar pattern is playing out as governments seek more control over the open internet. Last summer, a new data retention law in India forced NordVPN to shutter its servers there, and the company's website has long been blocked in mainland China. Meanwhile, as social unrest and geopolitical issues erupt in Iran, Sri Lanka, Turkey and other places, data show demand for VPNs continues to surge.

Yet when I ask whether these affected populations are downloading NordVPN, Okman says no. Instead, they tend to rush to free VPNs, which, though less secure and possibly dodgy, can grant swift access to Twitter and the BBC. Nord does offer free VPN access on a case-by-case basis to at-risk reporters and dissidents, but Okman says the company can't open the service to the masses. "Our servers would explode," he says. Sabaliauskas says they briefly considered implementing a free VPN program for Russian citizens but were advised by Ukrainian officials that they likely wouldn't use it for organizing protests but rather for surfing the web like they did before the war. "We chose not to participate in this," he says.

As Okman steers the conversation away from geopolitics and back to humdrum cyberthreats—"My mom was, like, 'Oh my God, I got this email. Is this a scam?'"—it becomes clear Edward Snowden types aren't Nord's target demographic. About 40% of its sales are in the US, followed by other democratic markets including Australia and the UK.

In an earlier phone call, Okman shared conflicting views on Nord's higher purpose. "We are not upsetting governments. We're not doing anything aggressive," he said. At another point, though, he said that protecting journalists and freedom fighters is core to his mission and that Nord works closely with Access Now, a digital rights organization.

But Natalia Krapiva, a lawyer for the group that advises activists on choosing security tools, says she usually recommends VPNs from Mullvad, Proton and TunnelBear, rather than Nord. "There's not necessarily anything bad with it, but we haven't had enough understanding of their security audits," she says. Even those behind her recommended products warn that they're no panacea. "If you're Snowden, you have a threat model that's pretty high and the NSA on the other side—a VPN doesn't help at all," Mullvad's Jonsson says.

That Nord seems more focused on building some new-age Norton than disrupting the Kremlin's internet censorship is surprising, especially given that Okman was born when the Soviets were still imprisoning Lithuanian dissidents and that Sabaliauskas's parents "were always saying it was such a terrible time and that we can never go f---ing back there," he tells me. Okman, though, says he doesn't draw a connection between that history and their development of tools that could potentially thwart authoritarian regimes from raising more digital Iron Curtains.

It's possible Okman is playing down this use case to avoid kicking the hornet's nest, but he does sound more motivated to expand Nord into a global brand and build Vilnius into a tech hub, which is arguably a different kind of protest against Moscow. "You have all these people who grew up in the middle of a big transition—getting the Soviets out. It's dead poor," says Thomas Plantenga, CEO of e-commerce company Vinted, the country's only other unicorn. "And you have these bright people like Tomas [Okman] and Eimantas [Sabaliauskas] who are full of energy and just want to prove you can build stuff from Lithuania."

I hear a similar sentiment from Ausrine Armonaite, Lithuania's minister of the economy and innovation, whose office is across from the Soviet station where the KGB used to spy on phone and radio communications. She focuses on the homegrown entrepreneurship Nord symbolizes instead of how VPNs can play a role in geopolitics. Ditto Vilnius's mayor, Remigijus Simasius, who has an enormous banner hanging outside his window that reads, "Putin, the Hague is waiting for you," yet spends much of our conversation pitching the country's thriving tech sector.

Still, the more aggressive internet censors become, the more they'll bring attention to VPNs and, by extension, Nord's products. When NetBlocks, a widely followed tracker of web interferences, tweeted that Jordan was restricting access to TikTok, it recommended Surfshark to circumvent the ban. (Founder Alp Toker clarifies that this endorsement was part of a sponsorship and that NetBlocks doesn't compare VPNs.) And when Italy barred access to ChatGPT in late March, *Cybernews* wrote an article about the best VPNs for unblocking the chatbot. It ranked NordVPN No. 1. Ⓑ

BY Tyler J. Kelley

ILLUSTRATION BY Giacomo Gambineri

After giving up his Comedy Central show, Dave Chappelle returned to his Ohio hometown and began living a low-key life. Then he started buying properties, complained about his neighbors on *Saturday Night Live* and waged an epic battle over development

America's most reclusive comedian isn't hard to find. Dave Chappelle hangs around downtown, buys coffee and shops like any other resident of Yellow Springs, Ohio. He smokes cigarettes and chats with passersby. He knows people, and they know him.

Yellow Springs is a special place. "Growing up here, literally on any given Saturday or Sunday, in any house that you walked into, there was going to be someone who was Jewish, someone who was an atheist, someone from a different country, somebody who was a person of color," says Carmen Brown, a Black village council member whose family has lived in the town for 150 years. "There was going to be a clown, an astrophysicist, a janitor and a doctor—all hanging out." Chappelle is a product of this environment, this culture of "discourse without discord," she says.

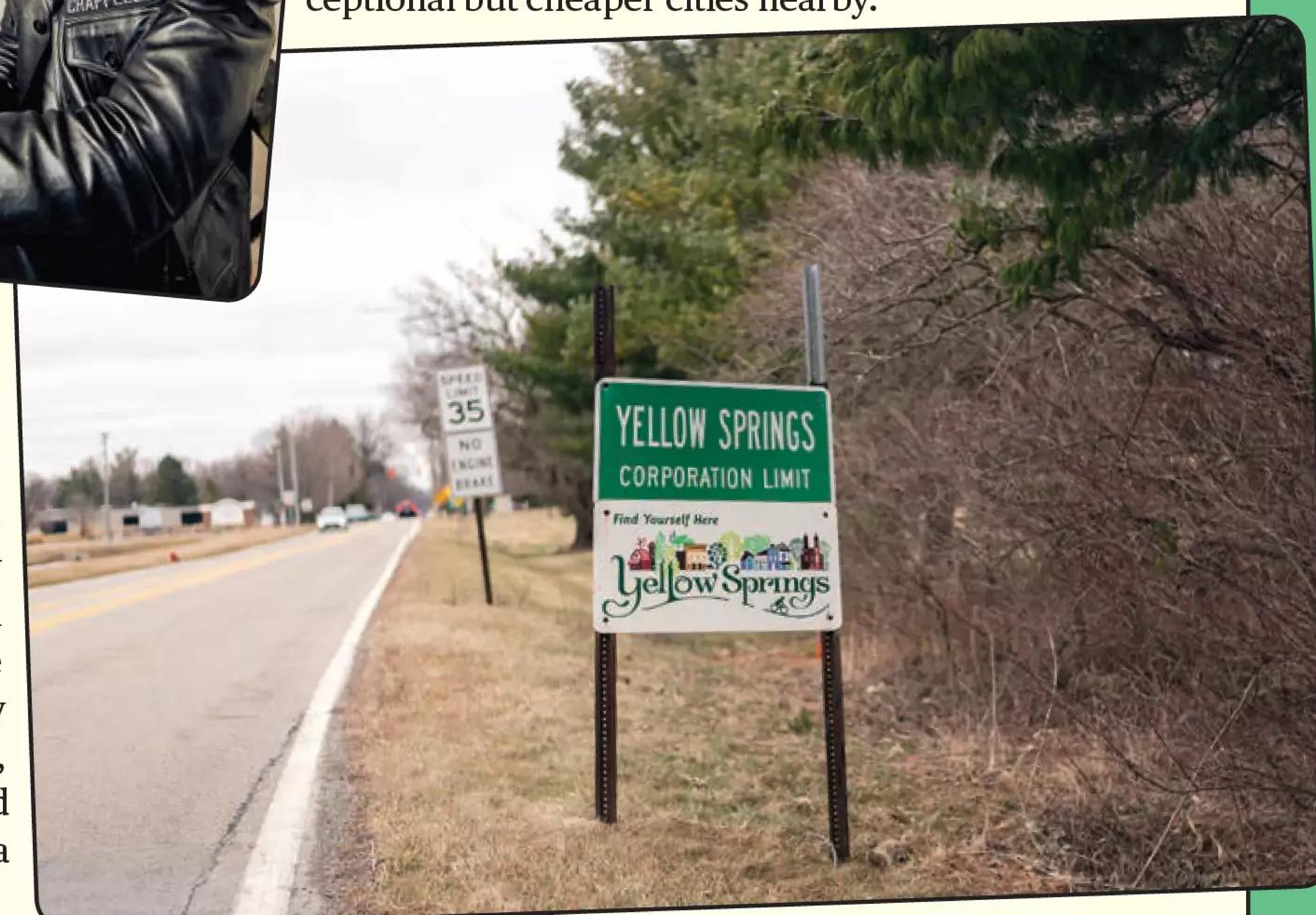
CHAPPELLE

A sign at First Presbyterian Church sums up village politics: "10:30 a.m. Sunday, an eco-feminist interpretation of Genesis 1:3, in person, masks required." Chappelle has called Yellow Springs, population 3,700, "a Bernie Sanders island in a Trump sea." The town was a stop on the underground railroad and an early home for formerly enslaved people who'd bought or escaped with their freedom. Coretta Scott King was one of the first Black pupils at Antioch College, the famously liberal outpost where Chappelle's father, Bill, taught in the music department and co-founded the civil rights organization Help Us Make a Nation, or H.U.M.A.N.

For decades, good jobs could be found at several innovative companies incubated at Antioch. The best-known, Vernay Laboratories Inc., invented a widely used thermostat for internal combustion engines. But as with many Midwestern industries, the manufacturing jobs these companies created have mostly disappeared. Vernay demolished its plant in 2009, leaving the village with a library, a day-care center and toxic groundwater to remember it by. Antioch itself shut down in 2008. It reopened three years later, but enrollment now hovers around 100, compared with nearly 2,500 in 1972. What remains for Yellow Springs is tourism, a draw since the early 19th century, when wealthy Cincinnatians began arriving to bathe in the ferric waters that give the village its name. These days, tourism is mostly a crystals-and-tie-dye affair.

Yellow Springs owes its sense of community and its desirability as a place to live in part to farsighted planning decisions that emphasized its downtown core and preserved a greenbelt of parks and farms around it. "If there was just one retail focus, then socially you're more likely to bump into your buddy across town," says Don Hollister, a township trustee who chaired a 1972 task force that decided against developing three commercial strips on the village's outskirts.

When housing supply is constant and demand rises, though, so do prices. A two-bedroom, one-bath home on 0.3 acres can cost as much as $275,000; Airbnbs have proliferated, and potential long-term rentals are being "gobbled up by older villagers who want to subsidize their ability to continue to live in town," says Reilly Dixon, a reporter for the *Yellow Springs News*. The tight housing supply has left Yellow Springs richer, older and Whiter. As of 2020, the village was less than 11% Black, down from 26% in 1970. With no condos or apartments to downsize into, retirees keep their underoccupied homes off the market, while young families and service workers end up in the unexceptional but cheaper cities nearby.



ENTERING TOWN

Chappelle spent most of his childhood with his mother in Washington, DC, but lived with his father in Yellow Springs while attending middle school. He bought a home in Ohio in the late 1990s and moved back full time in 2004, after giving up the Comedy Central show that made him a megastar and millions of the dollars that went with it. *Chappelle's Show*, which featured the comic playing characters such as Prince, Rick James and a Black White supremacist named Clayton Bigsby, drew widespread praise for satirizing the realities of Black life and the tensions between White and Black Americans. But sparked by what Chappelle later said was hearing the wrong kind of laugh while performing a skit in blackface, he abruptly left the show. While rumors spread that he was on drugs, in rehab, in a psych ward or on a spiritual journey in South Africa, Chappelle was in fact mostly in Yellow Springs with his family.

Nationally, he continued to tour, do stand-up and make

films, but locally he kept a low profile—at least for a while. In 2015 he began hosting occasional concerts in a nearby barn, calling the shows Juke Joints. Two years later, CNN covered a "rare public appearance" in which Chappelle went before the village council to call for police reform after officers tackled a man and tried to tase him during a New Year's Eve celebration. The year after that—armed with a contract from Netflix promising $20 million per comedy special, according to the *New York Post*—he incorporated Iron Table Holdings LLC and began buying properties downtown.

In June 2020, with live performances around the world canceled because of the pandemic, Chappelle received permission from the governor of Ohio to begin a series of outdoor stand-up shows at an ornate wooden pavilion owned by a friend. Unlike the Juke Joints, these shows took place almost every weekend, which led several of the pavilion's neighbors to complain to the zoning inspector, who determined that the performances were a code violation. Chappelle discussed the controversy in a monologue on *Saturday Night Live* that November. "My town was dying," he said, so "I did shows in my neighbor's cornfield, and these shows were very successful and may have even helped save the town." A report he commissioned claimed that the events generated $12 million in direct and indirect economic activity for the state of Ohio, including $4 million for the village. (Hollister says he's "very skeptical" of the numbers.)

Chappelle made national news again when he fought to block a housing development planned for a field abutting his home. Locally, his ongoing property purchases were making people nervous. Yellow Springers are used to having input on practically everything that happens in their village, and Chappelle hadn't invited the kind of collaboration they were accustomed to, even as he talks freely with people in town and his representatives regularly present selected projects at public hearings. He also almost never talks to reporters, though he did provide one quote for this story through a representative. "With the decline of Antioch College several years ago, Yellow Springs lost its cultural anchor," Chappelle said. "My interest has always been in restoring the cultural and creative economy Antioch helped to foster and which made Yellow Springs a haven for art, music, culture and academia."

SHARP

Chappelle has a strong base of support in the village, where many institutions and businesses have benefited from his activities. The pandemic performances "brought magic and energy at a time when we needed it the most," wrote Brittany Baum, a business owner, in a typical letter to the zoning board.

"A few local businesses would not exist today if it weren't for the shows," Matthew Cole, the area's only CPA, wrote in another letter.

"When I look out on the street I see other people of color, I see people of other cultures," says Jamie Sharp, proprietor of Yellow Springs Toy Co., who grew up in the village during the same astrophysicist-and-clown era as Brown.

Few people will say anything critical of Chappelle on the record, citing fear of losing their jobs or customers. Off the record, locals from different racial backgrounds and different generations say things like:

Chappelle is "a force that's turning us into the place that we're all trying to stay away from."

"Dave's got to be the biggest contentious thing that I've ever seen pit neighbor against neighbor."

"If you close ranks, and then you decimate anybody that speaks against an idea you have, then how does that inform community, or build community, and how does that save a community?"

Several villagers compared Chappelle to former President Donald Trump for his propensity to, as one put it, "never apologize, double down and blame the other person."

Chappelle has continued making headlines this year. He's been attacked during his act, and he's joked about "the Jews," "the gays" and being a "TERF" (trans-exclusionary radical feminist); he's also been boycotted by Netflix staff and bro'd down—to boos—onstage in San Francisco with Elon Musk. But with some notable exceptions, most Yellow Springers don't seem exercised about what Chappelle does when he leaves town. They're more concerned about how their village is changing and what one wealthy resident is doing with his money.

For years after Chappelle moved back to Yellow Springs, his public presence was negligible: modest property purchases, occasional shows. Locals prided themselves on leaving him alone. He only became a controversial figure around town in the summer of 2020, when crowds started flocking to the Wirrig Pavilion, a sort of ornate wooden gazebo that sits on 34 acres of grass and trees ("cornfield show" moniker notwithstanding). By all accounts, it was a magical place to be that year, unless you lived nearby and objected to the noise and traffic.

The experience began as you and a guest were shuttled down a dark country road. At the entrance, you were temperature-checked or Covid-tested, then handed a mask with Chappelle's logo, a white "C" with a red stripe above it and a green one below. You either left your phone in the car or let it be sealed in a special pouch, then you were free to select socially distanced bistro chairs on the lawn. Food trucks and a swanky bathroom trailer were parked on-site. The shows, billed as *Dave Chappelle and Friends*, might include comedy with David Letterman, Chris Rock, Sarah Silverman or Jon Stewart; music from Erykah ▶

CHAPPELLE: MAARTEN DE BOER/CONTOUR BY GETTY IMAGES. SIGN, SHARP: PHOTOGRAPHS BY JOHN-DAVID RICHARDSON FOR BLOOMBERG BUSINESSWEEK

◀ Badu, Common, Talib Kweli or John Mayer; or fireworks, DJ sets and appearances by celebrities such as Jon Hamm.

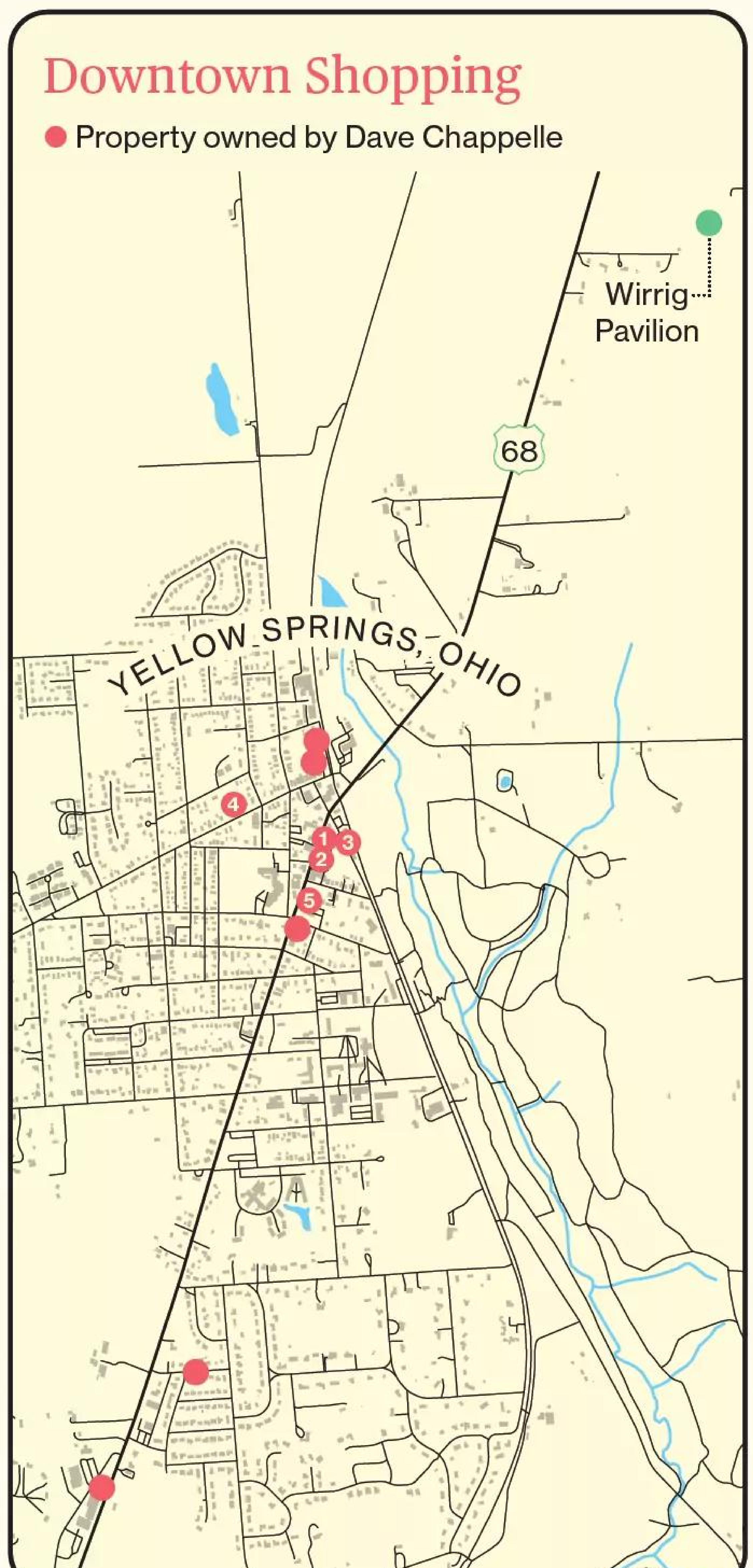
Ticket prices started at $200 per pair in 2020 and have gone as high as $500, with capacity rising, too, from 400 to 1,000. But while many residents were grateful for the shows, some didn't want an entertainment venue in their backyard. It fell to Richard Zopf, the township zoning inspector, to point out that local code prohibited large-scale commercial activity on such properties unless the activity was agricultural. Zopf ruled soon after the shows began that they didn't qualify and ordered them to stop.

In response, Chappelle's spokesperson, Carla Sims, appealed to the community's need for safe outdoor activities during the pandemic. "He's employing local residents, revitalizing local business and, hopefully, returning a sense of normalcy to the community," she wrote in a statement to the *Yellow Springs News*. Steve Wirrig, the owner of the pavilion property, ignored Zopf's order and filed an appeal. The shows continued in violation of the code for two months until Wirrig won a variance—an exemption, essentially—in August 2020. He was granted another in 2021. Wirrig, who until March was chief executive officer of Rohrer Corp., a leading packaging manufacturer with more than $200 million in revenue, penned at least one op-ed calling Zopf biased and obstructionist.

Wirrig didn't respond to multiple requests for comment. Zopf says, "I've been made out to be a bad guy by the property owner—so what." He points out that in 20 years as a zoning inspector—a "tiny little job" for which he's paid about $300 a month—he's "never had to deal with anything like the furor that has surrounded these shows."

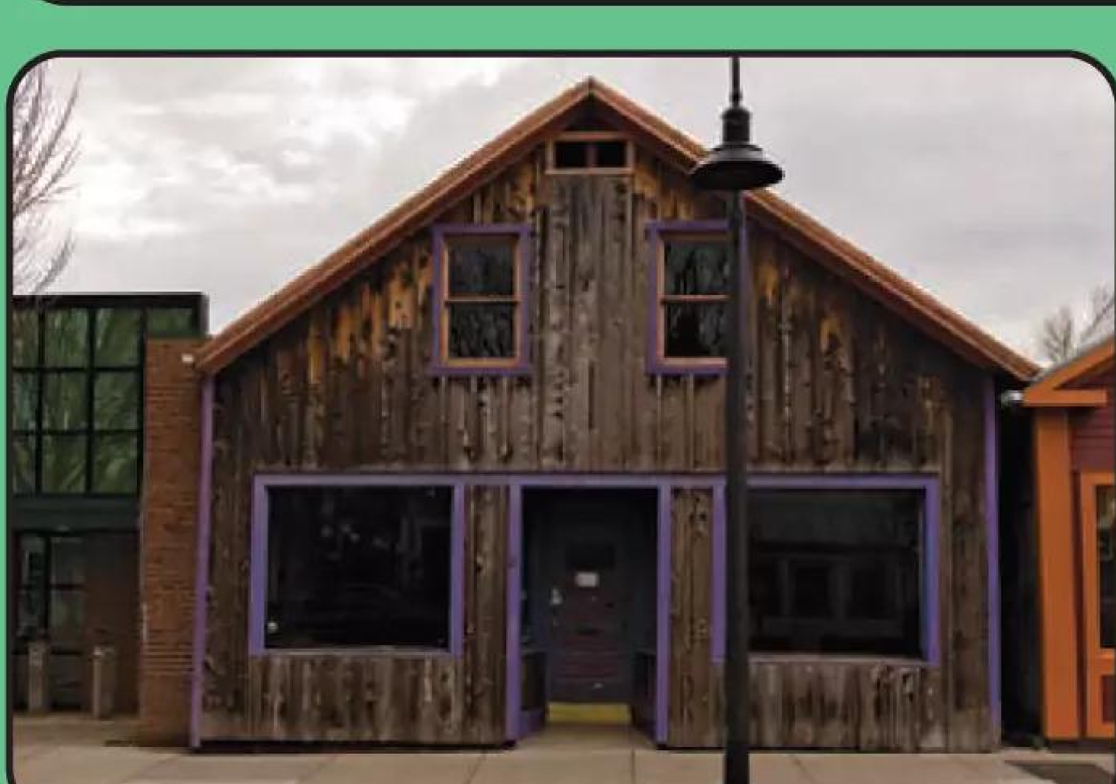
In his *SNL* monologue, Chappelle said, "The local farmers, my neighbors, started to complain that my shows were too noisy—in a cornfield!" He described the ensuing town meeting as "embarrassing" and said, "I resented it, I resented that these country farmers could decide a guy like me's fate. People don't deserve to do that. They haven't seen enough. They don't know anything." He then joked at their expense for a few minutes, wondering whether someone who complained about their kids hearing "the N-word" was overhearing it from Chappelle or saying it themselves.

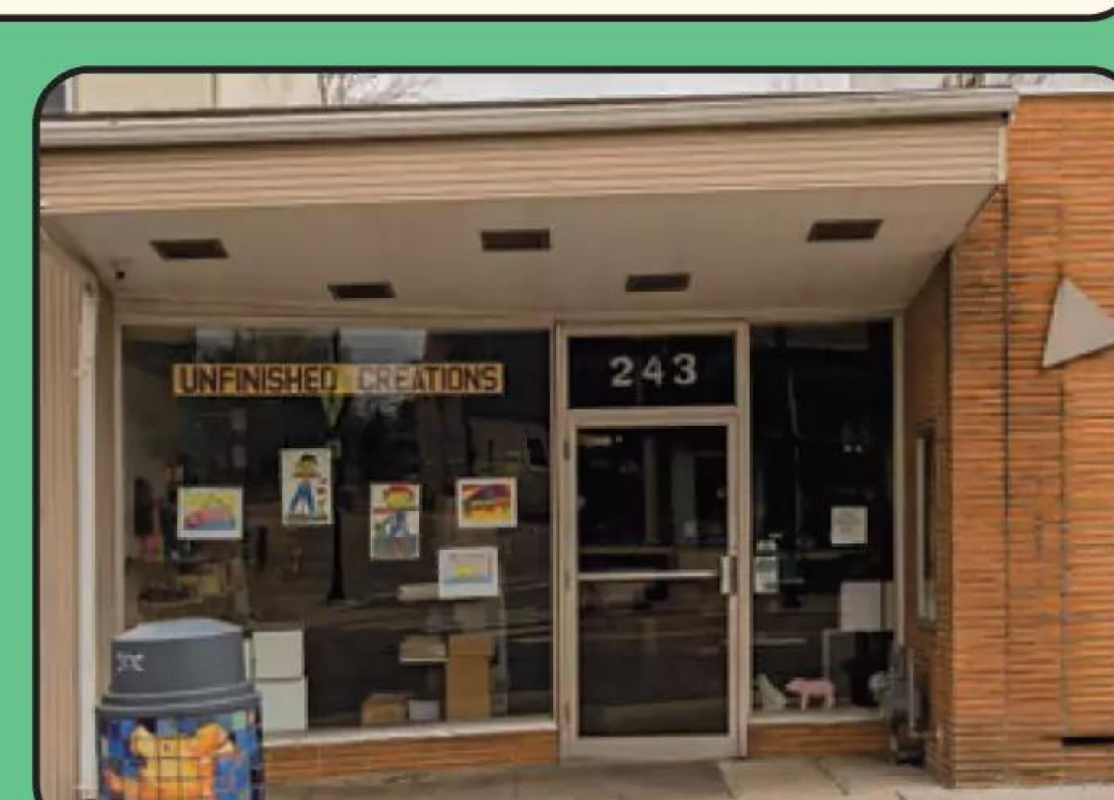
The cornfield-shows controversy dovetailed with Chappelle's increasing presence as a landholder in town. By 2020 he was flush with Netflix money, and over the next two years he bought eight properties through Iron Table Holdings and one in his own name, bringing his total in the county to 20.



Chappelle's holdings are clustered along the village's three major thoroughfares, and they run the gamut from newly renovated to nearly abandoned. In August, a brief tour showed carpentry underway at the brick home beside the library (bought for $390,000), while insulation appeared to be going into the old schoolhouse ($480,000) where Chappelle is building a new home for the local NPR affiliate. The former firehouse ($424,000), where a comedy club and restaurant have been promised, stood vacant (renovations began in January). There was no sign of a proposed overhaul of the property where Chappelle maintains an unofficial office, a white brick storefront that he's owned along with the buildings on either side since 2018 ($582,000 for all three).

On the same block is another storefront, once home to Earth Rose, a retailer of Birkenstocks and hippie novelties, which Chappelle bought when the owner died in 2021 ($400,000). It sits empty, but in December his architect announced plans to tear it down and build a modernist two-story structure in its place. A block away in the other direction is a whimsical brick





❶ FORMER SITE OF EARTH ROSE

❷ GLEN GARDEN GIFTS AND UNFINISHED CREATIONS

PHOTOGRAPHS BY JOHN-DAVID RICHARDSON FOR BLOOMBERG BUSINESSWEEK. DATA: GREENE COUNTY URECA

building ($485,000) that houses a tobacconist called the Smoking Octopus and Chappelle's merchandise store, where "C"-branded socks go for $12, wristbands for $5 and hats for $20. One hoodie, displaying Chappelle's face above ominous-looking flames, reads "Kindness Conspiracy," a motto he's cast as a rebuke to cancel culture: Instead of being offended and censorious, let's be empathetic, kind and tolerant.

In June 2021, Sharp organized a meeting of downtown business owners, including Chappelle. She thought they needed to have a stronger voice in local government, and the agenda included a slide show on the history of business in Yellow Springs and a presentation by the chamber of commerce. The meeting wasn't supposed to be about Chappelle per se, though another item listed on the agenda was "Dave is up to something." Discord—what Sharp calls "wild speculation"—was growing over Chappelle's activities, and she thought it was "important for people to understand what his plans were, what his vision was."

For some attendees the meeting's setting—the Wirrig Pavilion, at Chappelle's invitation—made it feel one-sided from the start. Chappelle introduced Sharp; his consultants later touted the economic benefits of his cornfield shows; and an architect showed slides of the schoolhouse remodel. When Chappelle returned to the stage at the end, he "shared his vision of the town being a cultural mecca," Sharp says, "and invited us to climb on board."

In the process, he also offered an expletive-laden accounting of everything he was doing for Yellow Springs. He'd bought new uniforms for school basketball teams, hadn't charged his tenants rent during the pandemic and had hosted concerts and fundraisers for the victims of a shooting in nearby Dayton. He was bringing in millions of dollars, he said, yet the assembled businesspeople remained suspicious of his efforts. This made him feel insulted and disrespected, he went on. Some neighbors had shot guns on their property during his shows, and others were writing letters to get the events canceled. He claimed that if the shows stopped, at least 20 locals would lose their jobs.

One attendee characterized it as a half-hour of him "talking to us about what we weren't doing right." Another says, "I have never seen anything more disrespectful to a group of people in my life."

Sharp felt the meeting was a success; it brought people together and led to the creation of a downtown business association. Mark Heise, co-owner of Yellow Springer Tees & Promotions and president of the chamber of commerce, says he took Chappelle's story of hurt and disrespect to heart. "Because he has money," Heise recalls, "he was made to feel like he was an outsider in his own town, and that's wrong." The morning after the meeting, Heise went to his shop and printed scores of window signs reading "Thanks Dave! Respect," with Chappelle's logo for the "c." Soon more than half the downtown businesses had a sign.

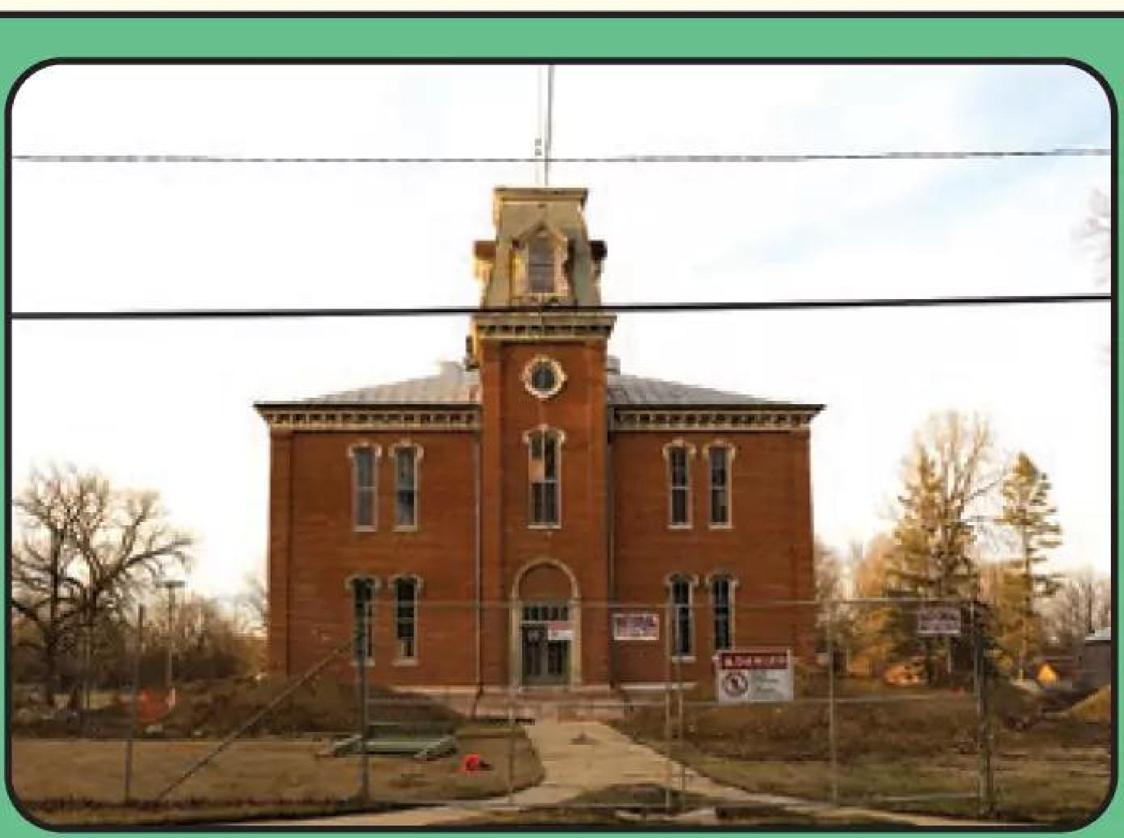
"If you didn't put it up, it meant something," Sharp says. For some, the sign meant thanking the comedian for keeping businesses afloat during the pandemic; for others, it meant pledging fealty to a cult of personality. Sharp says she put hers up for the first reason.

As Chappelle became more divisive at home, he continued to reintroduce himself to America, with sold-out performances, Netflix specials and *Saturday Night Live* hosting gigs. He developed lengthy monologues that were more earnest and political than his earlier work. He also took on a wider array of subjects, applying his trademark willingness to offend and his knack for verbalizing what many Americans are thinking but—for better or worse—are unwilling to say out loud.

One person who watched with particular interest was Iden Crockett, the self-described "only Black trans woman who is neighbors with Dave in the world." Crockett grew up in Yellow Springs, the child of a jeweler and an art teacher. She was a firefighter and paramedic for 24 years and now works solely as the latter.

Crockett counts herself a fan of Chappelle's and thinks some of the criticism he's faced is unfair. People see Chappelle buying property and proposing renovations, she says, "and they then extrapolate inappropriately," thinking things like "It's Dave's fault I can't afford to live here anymore." On the other hand: "There's a lot of people around here who go along with whatever Dave says, good or bad. There's very few people who evaluate each of his actions as a separate thing. People, maybe even subconsciously, want to rally for Dave." ▶

③ THE OLD FIREHOUSE



④ THE OLD SCHOOLHOUSE

⑤ SMOKING OCTOPUS AND CHAPPELLE MERCH STORE

◀ They want "that splatter effect of coolness."

Everyone seems to take Chappelle's words and deeds personally, Crockett says. She tries not to, but when Chappelle released his Netflix special *The Closer* in October 2021, she decided to say something. The special included jokes about trans people that were widely condemned as cruel and hateful. Netflix employees staged a walkout over its release, and Chappelle said it led distributors to back away from a documentary he'd made.

CROCKETT

He'd been doing versions of the same material at the Wirrig Pavilion all summer, prior to the special's filming in Detroit—to muted local response, despite the pride flags that seem to adorn every window and lawn in town. Crockett took exception, though, particularly to Chappelle's comparison of trans women to blackface performers. In a letter published in the *Yellow Springs News* after the special came out, she wrote: "My reaction to hearing my life, my day-to-day existence, compared casually to one of the most infamous and widely condemned racist traditions in the country, was shock. It was outrage. It was heartbreak."

Sitting at a table at the Underdog Cafe, sketching a figure with its mouth sewn shut, she elaborated: "Because what he says in regards to the life of Black men in the country is so spot on and so insightful, he gets a lot of credit, people go to him for his opinions. He is an expert on that, because he is a Black man in America." But "he's not a trans woman in America. And to speak with authority on trans-ness when you're not—and you clearly don't understand—is problematic and dangerous, because other people who don't understand look at you and assume that you do."

In a town like Yellow Springs, Crockett says, where there are no other celebrities, "he's a huge deal," so the things he says and does "have a weight assigned to them that is disproportionate to their real-world effect." At the same time, she's skeptical of the response to Chappelle's property purchases. "I hope that it's not racial," she says, "but you kind of can't help read it that way."

Bomani Moyenda, a Black community organizer who worked with Dave's father, recalls a White woman telling him in a grocery-store parking lot, "I never thought I'd be living in a town owned by a Black man." Then, Moyenda says, "she said something about not feeling safe, as if his presence presented some sort of threat." The incident reminded him of a scene in the film *Malcolm X*, in which Denzel Washington, playing the title role, goes into a police station to demand the release of a Black prisoner who'd been beaten. A group of his followers waits outside. When Malcolm X is satisfied that the man is being treated decently, he returns to the street and raises his hand, and his dapper, disciplined supporters march off in lockstep. "This cop says, 'That's way too much power for a Black man,' and I really think it's related to that," Moyenda says. "White people here are for the most part OK with Black folks being middle-class, or affluent even, as long as they don't make any waves." White people in Yellow Springs can't control what Chappelle is doing with his power and money, Moyenda says, and that disturbs them.

MOYENDA

Last year Chappelle brought his power to bear on 53 undeveloped acres next to his home at the south end of the village. Sometime before November 2020, the owners had offered to sell the property to Chappelle, who declined. They sold it instead to Oberer Land Developers, a regional homebuilder, for $1.7 million.

Oberer worked with the village of Yellow Springs to design a residential development that would include 64 single-family homes, 52 duplexes and 24 townhomes, with prices starting in the mid-$200,000s. Oberer would also donate 1.75 acres to the village where up to 30 affordable housing units could one day be built.

When the plan became public in the fall of 2021, Chappelle began rallying opposition to it. His spokesperson, Sims, later told the *Daily Mail*: "It was going to attract interlopers. Dave was trying to make sure that the people that live in Yellow Springs can stay and afford to live in Yellow Springs."

The village council held a virtual public meeting on Feb. 7, 2022, to be followed immediately by a vote on whether to approve the plan. The "vote no" contingent rented a hotel ballroom and arranged to broadcast their public comments from there. Many of those present wore Chappelle-branded face masks; they cheered and laughed, and at times it felt as though the soul of the community opposed the plan.

The development would "begin the erosion of cultural diversity and our uniqueness" and open the door to "Panera Bread, Walmart, Cracker Barrel," one speaker said.

The plan was "disingenuous," "offensive," "predatory," said another.

The "yes" voters, isolated on their webcams, argued that more housing stock would ultimately lead to lower prices. "The fact that we stopped development for decades is why we're in the problem we have with a lack of housing, a lack of diversity and a lack of availability," one said. Another argued that a new development would free up some of the village's older, cheaper homes for first-time buyers.

Chappelle took the mic last. Over the past few years, according to a person familiar with the situation who wasn't

“I cannot believe you would make me audition—for you,” Chappelle said. “You look like clowns”

authorized to speak publicly about Chappelle’s affairs, the comedian had grown frustrated with what he perceived as local opposition to his development projects. He thought his initiatives took longer and faced more scrutiny than other people’s. He’d previously threatened to liquidate his holdings in the village, and his comments that night were understood as a reiteration of that threat. “I cannot believe you would make me audition—for you,” he said. “You look like clowns. I am not bluffing. I will take it all off the table. That’s all. Thank you.”

(In a later statement to *Bloomberg Businessweek*, Sims said: “Unfortunately, the Council’s decision to open its doors to developers who would compromise the unique character and culture of the village is completely inconsistent with Dave’s development plans and their otherwise shared vision. It was as if some Council members would have rather opened the gates to a Trojan Horse than accept a gifted horse of their own.” Oberer didn’t respond to multiple requests for comment.)

The vote was 2-2 with one recusal, meaning the motion failed. “Had he not threatened to take his toys and go home,” says Dixon, the reporter, “had he not rallied a cabal of acolytes, I really think it would have passed.” Dixon supports the goal of creating more homes in the community. “I certainly could not afford to buy a $300,000 single-family home, but I probably could afford to pay $1,200 a month with my fiancée for a newly furnished duplex,” he says.

BROWN

Carmen Brown cast the final “no” vote. At the time the newest council member, she’d been elected on a platform of helping the working class of Yellow Springs—servers, retail clerks and others “who make this place move,” she says. “None of them were going to be able to afford a $200,000 house.” She herself had been a barista and occasional server when Chappelle’s cornfield shows began, and she’d watched as her tips quintupled on show nights. The planned development, in her view, wouldn’t have done anything for people in similar situations.

The vote became national news. “Dave Chappelle’s Latest Achievement: Helping Kill an Affordable Housing Development,” read a headline from *Rolling Stone*. Never mind that it never had been an affordable housing development. “It’s insulting for me—and a lot of people—to assume that just because another human being says something, that we are instantly influenced regardless of who that person is,” Brown says. There’s an “entirely incorrect” assumption, she added later, “that people of color are inherently influenced by the opinions of others.”

In the aftermath of the vote, a new crop of “Thanks Dave” signs appeared around town. County records show that this past April, Chappelle quietly bought the 52-acre site. No one knows his plans for the property.

While Chappelle was acquiring the Oberer land, Wirrig was going before the zoning board of appeals to get a new variance for the 2022 cornfield shows. The pandemic justification was mostly gone, opening up the question of whether an exception for large-scale nonagricultural commercial activity was still warranted.

At least one board member, Linda Parsons, felt it wasn’t. On the day of the vote last April, Parsons, a White retiree who lives a few miles from Wirrig’s field, arrived at the firehouse where the board would make its decision. The building was crammed with Chappelle supporters. “People are glaring at you,” she recalls. “We didn’t know who the heck they were.”

Dozens spoke in favor of granting the variance, mostly touting the economic benefit of the shows. Despite her doubts, Parsons voted yes. The measure passed unanimously. “When push came to shove, we caved,” she says. “I felt so dirty afterwards.” She took the weekend to think it over, then quit the board. “If I haven’t got enough guts to stand up for what I believe, I’m not serving the people,” she says. The village has always been “weirdly dysfunctional,” she went on, but “now it’s not a fun dysfunction, and there’s people who are afraid.”

With the variance granted, the shows carried on until the end of the summer. In the village, the T-shirt shop sold more T-shirts, the restaurants sold more dinners, and the record store sold more comedy records. The celebrities arrived, the fans were happy, the jokes were funny. Meanwhile, the tensions of past years continued to bubble beneath the surface like sulfurous spring water.

Chappelle seems aware that his fame is both a help and a hindrance in Yellow Springs. During his *SNL* monologue back in 2020, he imagined a fellow villager saying, “Honey, come quick, come quick, the guy from the grocery store is on television!” Chappelle’s response: “No, you big dummy, the guy from television is at the grocery store.” He certainly couldn’t have put on his cornfield shows if he weren’t the guy from television first. Yet in discussing Chappelle’s property purchases, Sims stresses that he should be afforded the same right to privacy as any other citizen. “None of his neighbors have had press conferences about what they’re doing with their personal property,” she says.

On the streets of Yellow Springs, Chappelle is clearly viewed as someone exceptional. One sunny Friday morning last August, the village manager, Josue Salmeron, who’d represented Yellow Springs in negotiations with Oberer, was chatting with Cole, the CPA, outside the Underdog Cafe.

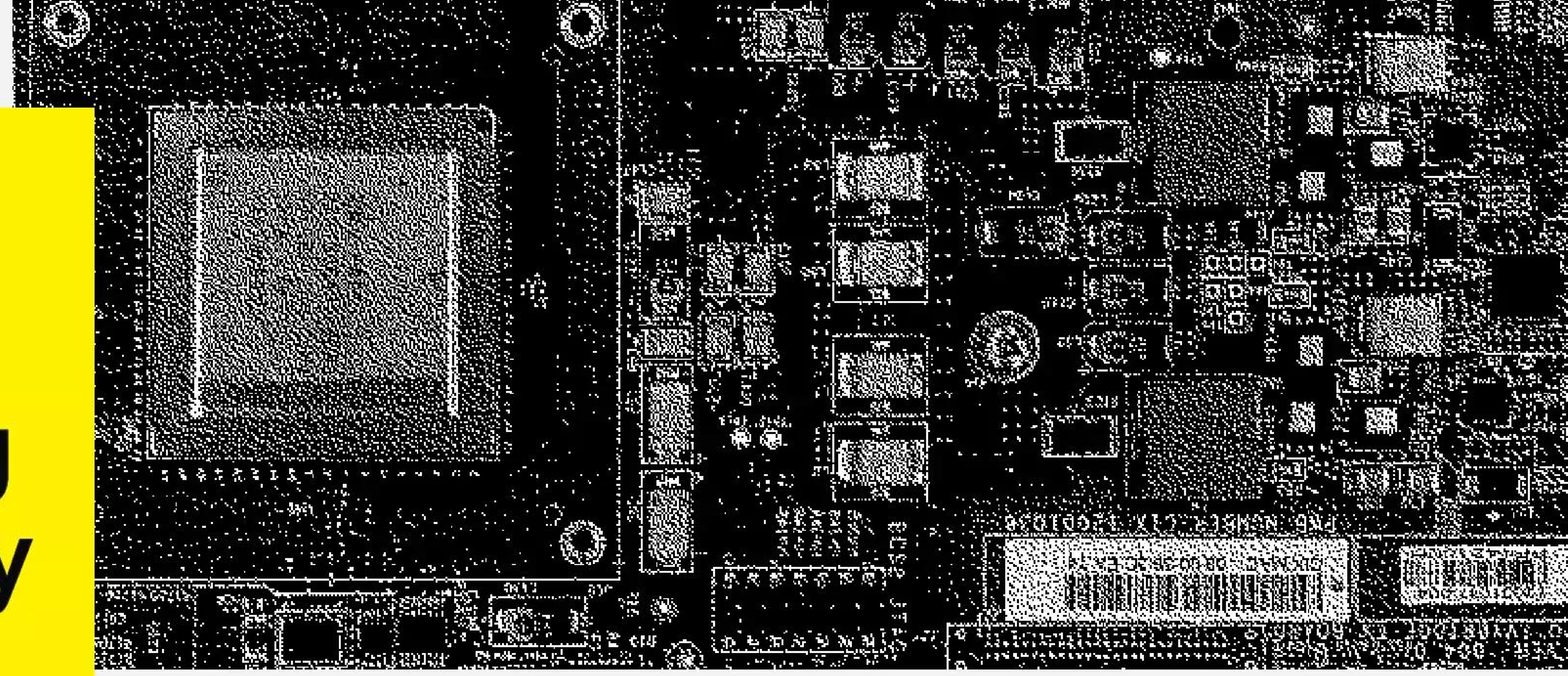
“The town needs a Joan of Arc to push for change or die trying,” Salmeron said. “I think Dave is that person.”

“*Is* Dave that person?” Cole replied.

Others are wondering, too. Sharp doesn’t want Yellow Springs to become any less affordable or any less diverse, but she knows it will if the free market has its way.

“Dave can be a savior, or he can not be,” she says. “He doesn’t really owe us anything.” B

PHOTOGRAPHS BY JOHN-DAVID RICHARDSON FOR BLOOMBERG BUSINESSWEEK



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REGISTER NOW

Calling the Shots

Tequila and mezcal are booming. And female-helmed brands are making sure Mexican women are profiting, too

By Ella Cerón and Maya Averbuch
Photograph by Alicia Vera

From left: Casa Del Sol's Alejandra Pelayo, Mariana Padilla and Carmen González on an agave farm in Tepatitlán de Morelos, Mexico

May 1, 2023

Edited by Chris Rovzar

Businessweek.com

The first tequila company Carmen González worked for didn't last long. The owner raced in his car on Thursdays—if he won, he paid her and the other employees; if he didn't, they'd wait weeks for a paycheck. It was 2008, a time when the liquor industry had turned her home state of Jalisco into the star of one of Mexico's most famous exports, yet the most prominent women in the field were the ones on billboards, scantily clad.

"As a woman, as a chemist, I wasn't looked at right," she says. A laboratory analyst, she was tasked with verifying everything from the sugar content of agave juice to the distilled alcohol's proof. When she was refused a raise beyond her $100-a-week salary, she walked out. Now, 15 years later, she's the *maestra tequilera* (master distiller) at Casa Del Sol Spirits Co., part of a growing roster of tequila companies that are not only elevating women but also basing business decisions around their needs.

Only 11 of the 174 registered tequila distilleries were headed by women in 2022, according to the national Consejo Regulador del Tequila, which regulates production. (Other distilleries, called *palenques*, produce mezcal on a more artisanal scale.) But women, of course, have been involved in tequila and mezcal for centuries. Historically they planted seeds and prepared food for the *jimadores* (agave farmers), picked up slack in the production line by bottling batches and—as popular legend has it—smuggled their wares to market and brought the money safely home. But as economies of scale led to large industrial operations with stricter government oversight, the opportunities a smaller family distiller might offer women didn't always follow.

Casa Del Sol has made inclusion a core value. The brand was founded in 2021 by Chief Executive Officer Steph Sebbag and his four partners, all women with equity stakes, including actress and producer Eva Longoria. "A lot of the tequila you see on the shelves is Mexican-made, but it's not Mexican-owned," Longoria says, noting that she'd been courted to go in on a tequila ever since her breakout on *Desperate Housewives*.

The company, which has headquarters in California and Jalisco, earned her "yes," Longoria says, largely because of its team of women. That included those in Mexico, who knew the right industry players to navigate production, and women in the US, who knew how to market a luxury good at events such as Art Basel Miami Beach and the Houston rodeo. "We're able to focus on building this brand that has purpose," she says. "It stands for a lot more than, 'Hey, let's make a quick buck on a tequila.'"

Since George Clooney sold Casamigos to Diageo Plc for $1 billion in 2017, everyone from Dwayne "the Rock" Johnson to Kendall Jenner to Diddy has sought to cash in on the tequila boom. Jim Cramer has a mezcal, as do Aaron Paul and Bryan Cranston of *Breaking Bad*. This celebrity cash grab gets attention, but consumers are increasingly wary of cultural appropriation. That Mexican and Mexican-American women are beginning to carve out a piece of their country's cultural heritage for themselves is significant.

In 2022, $4.1 billion in tequila was exported from Mexico, up 116% from $1.9 billion in 2019, per data from Banco de México; Americans sucked up 81% of this, according to the national tequila regulator, with women edging out men in consumption. The value of mezcal exports more than doubled, from $74.2 million to $162.5 million, in the same period.

Susan Coss, co-founder of industry website Mezcalistas, says success begets success. "There are the big names out there," she says, citing leaders such as Real Minero's *mezcalera* Graciela Ángeles Carreño. They're "women who have really been pushing the conversation forward and being role models for other women…to start their own operations."

That list also includes Melly Barajas Cárdenas, the powerhouse behind the Vinos y Licores Azteca group, who began working in tequila 27 years ago. She hires mostly women at all levels of production, at her Raza Azteca distillery, including in the fields; housing and educational support is also available. The distillery's well-regarded brands include Leyenda de México and La Gritona.

Sourcing Mezcal Like a Mexican

Under a *denominación de origen* law, producers in nine states are allowed to call their smoke-kissed spirits mezcal, and there's plenty to savor. Bars such as Mexico City's Bósforo and La Clandestina or Mezcaloteca in Oaxaca City are excellent places to start. But there's also a tradition of buying directly from the mezcaleras and mezcaleros who've produced the drink for generations.

Customers could casually approach makers and say, "I have a wedding coming up, and I want to get mezcal," says industry watcher Susan Coss. Restaurants and bars historically also had their own house brand. Rich flavor variations from state to state and batch to batch are what gave mezcal its craft reputation in the first place. Multinational investments and tax reforms across Mexico have since shifted that model. Outsize compound annual growth—38% from 2021 to 2026, according to an IWSR Drinks Market Analysis—will do that to an industry.

Still, many Mexicans seek out traditional mezcal direct from distilleries, often at very attractive prices, despite the legal gray area. Bulk sellers at *tianguis* (open-air markets) and *ferias* (festivals) might fill customers' empty plastic bottles. Tours with plenty of to-gos are popular in mezcal-producing regions.

Facebook groups post sales, and zinging around WhatsApp among thirsty fans, menus (like the one above) promise free delivery within cities. Sellers from Guerrero (@sanzekanmx), Guanajuato (@mezcal.hacienda_vergel_de_gpe) and Oaxaca (@cruz_de_olvido_mezcal), among others, offer mezcals on Instagram.

COURTESY COMPANIES

Maestra tequilera Bertha González Nieves, an alumna of José Cuervo International, co-founded Casa Dragones tequila in 2008. Sonya Vega left her public-relations company behind to launch Doña Vega mezcal in 2020, enlisting Hortensia Hernández Martínez, a fifth-generation mezcalera who works with her daughters in the fields and distillery every day.

For Casa Del Sol's González, entering the top ranks hasn't come without pushback in a long-male-dominated industry. To be considered for a supervising production role at another brand, she had to lobby executives to even let her apply. "I said, 'Just let me compete,'" she recalls, "because I knew that everyone else was a man. And I said to them, 'Women can do this work.'" After she got the job, she'd receive snide comments from co-workers over the radio. "There was a stigma against a woman giving instructions," she says.

Now, as maestra tequilera, she's in charge of product development and tasting to make sure Casa Del Sol's ultra-premium product line stays consistent. That means a semisweet whiff of caramel in the blanco and a compelling finish of dry fruit and dark chocolate in the $115 añejo, aged for at least 14 months in cognac barrels. The hard-earned role allows her the flexibility she needs–she can vary her hours and work from home–to juggle raising a 4-month-old and 17-month-old. Otherwise she wouldn't have taken the job.

This kind of accommodation to reality, that a regular eight-hour workday isn't feasible for many women, also informs a flexible work policy at Yola Mezcal. Co-founder Yola Jimenez prioritizes the hiring and advancement of women, with salaries above the local average. She stresses that financial empowerment not only drastically improves their lives, but it also benefits everyone. "When women have access to make their own decisions, children are healthier, and it creates a much more stable system for a community," she says; for her it's important that the bulk of the money she makes from Yola stays in mezcal's home state of Oaxaca.

A new facility that's under construction will function almost like a co-op for its women workers, with child care and a kitchen and opportunities to decide how it's run. A project like this is expensive, Jimenez says, but she's confident the palenque–designed by a female architect–can send ripples of change through the area when it opens next year.

For its part, Casa Del Sol strives to make good on its branding, which highlights Mayahuel, the Nahua goddess of agave. It's a nod to the Indigenous cultures in the areas surrounding Los Altos de Jalisco, where the company is based. "We are trying to honor and dignify the role of women in the industry," says Alejandra Pelayo, co-founder and vice president for Casa Del Sol's operations in Mexico, who previously worked at both Pernod Ricard SA and the Consejo Regulador del Tequila. "Twenty years ago, we used to see ads with women with low-cut clothes and a bottle of tequila. Our importance hasn't been recognized in the production process or in commercialization."

Put another way by Mariana Padilla, another co-founder in Mexico: "We want to be clear in our messaging. A woman can sit down and ask for her shot."

Other Women-Owned Brands to Know

1 Casa Dragones
Maestra tequilera Bertha González Nieves makes four luxury tequilas, each with distinct aging processes, and all are meant to be sipped. The reposado rests for at least two months in newly charred Japanese mizunara casks, layering a whisper of incense and sandalwood over a pleasantly spicy-sweet, almost citrus butterscotch base. *$170*

2 Real Minero
Graciela Ángeles Carreño's Real Minero brand, with a history stretching back to the 19th century, is labeled as "agave spirits" after bureaucratic headaches led the Oaxacan trailblazer to abandon official mezcal certification. Nothing inside the bottles has changed. Not least of all the soft and smooth cocoa and banana notes of its espadín, fermented in traditional clay pots rather than casks. *$120*

3 Yola Mezcal
Co-founder Yola Jimenez, who was born and raised in Mexico City, learned about distilling from her grandfather. With a team that includes the singer Lykke Li and master mezcalera Guadalupe Bautista, the brand prioritizes hiring women—and paying them fairly—to make an accessibly smoky spirit based on a family recipe, grinding the organic espadín and madre cuixe piñas with a tahona stone mill. *$49*

4 Doña Vega
Former PR executive Sonya Vega tapped into her Mexican heritage and connected with a fifth-generation mezcalera to turn out two expressions from Santiago Matatlán, the "world capital" of mezcal just outside Oaxaca City. The espadín's peppery finish makes it well-suited to spicy cocktails, but it's the lemony, leathery, light-on-smoke tobalá that's the real-deal sipper. *$130*

5 La Gritona
Packaged in green glass taken from recycled Coca-Cola bottles, La Gritona is just one of the stellar brands produced by co-owner Melly Barajas Cárdenas and her team of primarily women. The price point makes it a good all-purpose reposado to keep on your bar cart for cocktails, with the vanilla and pepper notes complementing the agave's natural vegetal taste. *$38*

The Leaders of the Pack

Stylish, practical backpacks are giving purses a run for their money

By Antonina Jedrzejczak Photographs by Takamasa Ota

Long before JanSport and L.L.Bean backpacks began filling the hallways of high schools, the original Duluth pack was designed in 1882 to help portage a canoe, with the wearer securing it in place with a thick strap across the forehead. In the ensuing decades, entrepreneurs would attempt to patent versions of the leather and sealskin rucksacks historically used by hunters, trappers and fishermen. Things settled down designwise after World War II (no more headgear, slightly fewer animal skins), with backpacks serving more quotidian roles in schools and offices.

Now, past the peak of the pandemic, many higher-end luxury brands have taken advantage of our increasingly fluid work routines to focus on functional style, says Nora Kleinewillinghoefer, associate partner at Kearney Holdings Ltd., a global strategy and management consulting firm. That means clothes and accessories should work both harder *and* smarter; even backpacks need to go from day to night. Professional two-strap bags are taking lessons from more chic counterparts and adding details such as leather accents and statement hardware. Vice versa, the most avant-garde styles rarely skip the laptop compartment. Clever designs that allow a pack to convert to a handheld or shoulder tote are making the need to carry both a purse and a "practical" bag obsolete. In total, "the global women's backpacks market is expected to grow at a compounded annual growth rate of 5.5% from 2022 to 2030," says Kleinewillinghoefer.

At Troubadour Goods, a bags and accessories brand, the hybrid reality has translated to a big boom. "We are now seeing backpack sales that are more than three times our best pre-pandemic levels," says co-founder Abel Samet.

Cuyana leather backpack
Available in 13- and 16-inch models, this pack has snaps on the side to allow you to adjust capacity and a generous top handle drop that makes it easy to sling over a shoulder. *$478; cuyana.com*

Burberry Check and Leather micro backpack
If you visited a mall in the 1990s, you remember micro backpacks. Reimagined this season by Burberry in its signature plaid, the 6-by-7-inch tote comes with the requisite drawstring closure. *$1,950; neimanmarcus.com*

Within the backpack bonanza, there's a smaller (quite literally) subtrend: From Burberry to Prada, the micro backpacks that defined the early 1990s are again dominating runways. "We are planning to release a few designs in the upcoming months to cater to the requests," says Ian Clegg, a co-owner of family-run Frank Clegg Leatherworks.

Even long-time wearers are finding much to love. "Customers upgrading their backpacks to new ones are pleasantly surprised," Samet says. "It's not just the gadgets in our lives that are getting better. The bags that we carry them in are improving dramatically as well."

Frank Clegg Classic backpack
At this small company in Fall River, Massachusetts, it's all about attention to detail. Handcrafted from smooth tumbled leather with solid brass hardware, this fittingly named pack will only get better with age. $1,095; *frankcleggleatherworks.com*

Troubadour Ember
Equally at home in the boardroom and on a weekend getaway, the smart, minimalist design of the Ember combines comfort and utility. Key features include ergonomic padded shoulder straps, a cushioned 16-inch laptop sleeve and a lightweight, waterproof body. *$195; troubadourgoods.com*

Graf Lantz Bedford
Made in the US from a sustainable mix of Oeko-Tex-certified merino wool felt and vegetable-tanned leather, the Bedford comes in a range of earth tones. Detachable straps allow it to be worn as a backpack, shoulder bag or cross-body. *$348; graflantz.com*

Monos Metro
A removable snap-on front pouch, a sturdy top handle, a 15-inch laptop sleeve, hidden pockets and waterproof compartments (for items such as a wet umbrella) make the Metro supremely versatile. *$200; monos.com*

Prada Small Re-Nylon
Since the Italian brand's first nylon backpack—the Vela—was created in 1984, the popularity of its nylon pieces hasn't wavered. This season's pastel blue Small Re-Nylon version uses recycled ocean plastic alongside traditional Saffiano leather details. *$1,950; prada.com*

Bottega Veneta Medium Intrecciato
At 18 inches tall, the Intrecciato is the ideal size to fit all your daily necessities in one big interior. Available in three shades (surf, the brightest color, is seen here), it's lined in sumptuous suede, with the brand's interwoven strips of calfskin leather offering a luxurious texture. *$4,200; bottegaveneta.com*

The ground floor of the newly remade flagship features giant digital screens that will play scenes of New York City

Tiffany & Co. Aims Higher

By Angelina Rascouet and Chris Rovzar

After a three-year renovation, Tiffany & Co. on April 28 reopened its Fifth Avenue flagship store, which it now calls the Landmark. In anticipation of the big day, Bloomberg Pursuits spoke to Anthony Ledru, chief executive officer of the American jewelry brand, which is now part of luxury giant LVMH Moët Hennessy Louis Vuitton SE. Among his many goals, he said, is to cater to a more elite clientele and skew the products to a steeper price point. The interview, which took place on April 21, has been edited for length and clarity.

The newly redone store looks amazing. What's your favorite part of the Landmark?
I have two. First, the ground floor—there's something very generous about it. And very American. The layout is the same as what we had in the 1940s, super inclusive. But when you get in, there is a beautiful skylight that brings light and modernity. And on each side [on digital screens] you have iconic scenes of New York, Central Park.

And my second favorite is the penthouse on the 10th floor, which is the opposite. It's super exclusive. It's for maybe one, two, three, maybe zero VIP clients a day.

In January, Bernard Arnault shared some numbers saying the temporary store was making about $200 million a year. He said the new one will do at least double that. Do you think you'll reach $400 million in sales? Do you have a date goal for that?
Obviously you would dream of higher numbers. You don't make these kind of investments not to see an impact. But the obsession is really about brand desirability. What we try to create is a dream. We're trying to add a really experiential, immersive and cultural dimension to the project.

It used to be the largest jewelry store in the world. That's fine. But I think we need to bring a lot more to the table in 2023. And those three dimensions that I mentioned will create the desirability. And that translates into transactions.

It's a much larger store than before. It literally takes hours to go through it. That's the reason why there is an experience that is different from one floor to another. The aesthetic approach from our past, which probably made sense in 1920, was consistency. I don't believe you could realize on which floor you were in the past. It was all the same.

It's very different today. You get surprised floor by floor. I think some people might spend half the day—they'll have lunch, breakfast or dinner at the [on-site] Blue Box Cafe by Daniel Boulud.

In the past there was a reliance on this particular store for 10% of Tiffany's sales. Do you think that's likely to increase? Or decline because of your other openings around the world?
It had an extraordinary weight in the past because Tiffany was also extraordinarily North American-centric, perhaps too much so. The strategy of the brand now is to expand, in Europe in particular. We have a potential in markets where

COURTESY TIFFANY & CO.

most of our competitors are at the really late stage. And yet when you think about Tiffany, we don't really have a flagship in Paris today.

Are you going to build one?
There's a lot of discussion. For sure we need one or two over there. Potentially we need one that's more intimate around Place Vendôme and a bigger one around Champs-Élysées, the equivalent of Fifth Avenue. We're already there, but we can do much better.

We're opening one in Milan on Via Monte Napoleone. Today we're right behind the Duomo. There's huge potential. We will also renovate our stores in London. So Europe first will be a big focus of work.

It's quite extraordinary this year what we're seeing in the Middle East, too. Dubai Mall, since the store reopening a week ago, has been really impressive. You look at Southeast Asia, it's the same approach. And of course we have the potential that everybody has in Greater China. We have our Ginza [Tokyo] flagship reopening in July.

Can we still grow in the Americas? I do believe the potential is equally big. We have not invested a lot in the past 10 years in terms of store innovations. That's the biggest opportunity for us.


Ledru

Can you give us a sense of how much the Landmark renovation cost?
No, I cannot, but it's the largest investment ever made by LVMH on a single store. I think that says a lot.

Does it reach a billion dollars?
No. Not reaching a billion at all.

Are there going to be new product lines or new categories that are tied to the store?
We have a few limited, beautiful watches. The push around watches will be on jewelry watches more than anything. There's one line called Tiffany 57, which will be in the range of $500,000. And then we have a Union Square watch, named after the flagship that we had in the 19th century.

There will be these limited editions, plus new watches next year around the Schlumberger line [named after 20th century Tiffany designer Jean Schlumberger]. We believe there's something very refined and high-end that can be done. Those watches will be around a hundred thousand dollars.

The point is to align the watch business with the jewelry business.

Since LVMH took over, Tiffany has done collaborations with sportswear brands Supreme and Nike. Some of your European rivals wouldn't engage in those types of collaborations. Do you think that's risky?
What's risky is not to take risk. On one side you have European brands mostly focusing on heritage, and I think it makes sense for them. Then you have fashion brands mostly focusing on modernity. We believe we're a bit of a mix between the two worlds. When you look at Tiffany, this is the way we've been operating for 186 years. On one side it's the Diamond Kings, Schlumberger, the White House. That's the heritage part. On the other side, Tiffany has been part of the pop culture. It launched the concept of house designers: Picasso, Peretti. It is really part of our DNA.

When we get criticized, that's probably a good sign. When you're referring to Nike, it's two legendary brands together.

In the store there's a lot of contemporary art that's in Tiffany Blue-ish shades, by artists like Basquiat and Daniel Arsham. Last year the dealer Larry Gagosian broke the auction record for an American artist when he bought Andy Warhol's *Shot Sage Blue Marilyn (1964)* for $195 million on behalf of an unnamed buyer. It's a similar color. When the store opens, will we see that artwork there?
No comment.

Is Tiffany experiencing a demand slowdown, notably in the US?
Clearly the world has been slowing down a bit. There were several headwinds in the past 12 months. We're still in good shape. We believe that the investments that we're making are for the long term. The Landmark, hopefully, for the next 50 or hundred years pays on the level of investments. You'll have up and downs in the US. It happened in 2001, 2008. The good news is it always comes back quite quickly in the US.

Can you tell us a little bit about the VIP services at the Landmark?
It's a big departure compared to before, since we used to have very few private areas. Now we have generous VIP areas, including the penthouse. It's close to 8,000 square feet—it's part of what we call "the diamond on the roof."

It seems like with LVMH, the sky's the limit when it comes to investment in a brand.
I think it's the big difference between being independent and listed on the stock market. I was at Tiffany pre-acquisition, so I know exactly what was possible and what was not possible. With LVMH we will have the means to meet our ambition. There is really that long-term view and long-term investment. With the Landmark, you're going to see the retail transformation that will happen in the next 24 months. When you have these three elements, it's a game changer: You have more traffic, you have more quality traffic, and you have happier clients that connect and stay longer. Ⓑ

PHOTOGRAPH BY FRANCIS AUGUSTO FOR BLOOMBERG BUSINESSWEEK

The £9 Oyster

At Bentley's in London, the native Kelly oyster will take a bite out of your wallet. *By Kate Krader*

In dining rooms around the world, oysters have become as standard as popcorn at the movies. Served glistening on platters, they continue to sell even as their price climbs. New York City restaurants routinely serve a half-dozen for $24. But it's the price of oysters in London that will catch people's attention. At Bentley's Oyster Bar & Grill, the clubby, century-old seafood house off Regent Street, a single Kelly oyster from Galway, Ireland, goes for £9 ($11). Can any one bivalve be that delicious?

Bentley's Kelly isn't covered in caviar or sprinkled with 24-karat gold flakes. It's a variety of native oyster, a species indigenous to shallow waters in Europe, Great Britain and Ireland. The reason for the eye-opening price tag is that the mollusks are rarely farmed, because they take almost six years to mature—not unlike a fine wine. (The more common rock oysters, which originally came from the Pacific Ocean, take about two years.)

Natives are available from September to April and then they're gone: It's illegal to harvest them in the warm summer months when they reproduce, which means you've got about two weeks left to try one that's already been pulled from the sea. Otherwise, your next opportunity will be the end of summer. At Bentley's, head shucker Federico Fiorillo says the restaurant spends more than £3 for each Kelly oyster and one-sixth of them have to be discarded when they don't meet Fiorillo's quality standards.

In an oyster beauty contest, the Kelly wouldn't win any prizes. It doesn't have the craggy, dramatic look of its deep-pocketed, tapered relatives; it looks more like an oyster that wants to be a clam, with a round, relatively flat and unremarkable shell. And the taste isn't notably briny, unlike the oysters that make you feel as if you're standing in the ocean as you slurp.

Instead, the Irish oyster has a meaty and nuanced taste that stays with you for several minutes. Not unlike that fine wine, it's an experience more than a mouthful. And like some of the more rarefied vintages I've sampled, it's not my new favorite. When it comes to oysters, I will take briny fresh over complex meatiness every day. But it's absolutely worth tasting something that's been hanging out in mineral-rich water for years, until it's shepherded to the shucker.

"They're basically a foodie's oyster, but they also represent tradition, they represent history," says Bobby Groves, head of oysters at André Balazs Properties, including Chiltern Firehouse in London, Chateau Marmont in Los Angeles and Sunset Beach on Shelter Island, New York. At Chiltern, the natives are sourced from West Mersea in Essex and sell for a relatively inexpensive £6. "They come from old Roman fishing grounds that reflect 2,000 years of oyster heritage," says Groves, who's also the author of *Oyster Isles: A Journey Through Britain and Ireland's Oysters*. If you're comparing the distinctiveness of natives to rock oysters, he adds, "rock oysters are chicken; natives are pheasant."

And they are, he says, selling extremely well from his oyster cart in the Chiltern courtyard, with glasses of Champagne and dry rieslings: "There's a big rush for them right now. People want to celebrate them while they're here."

Likewise, the £9 Kellys are popular at Bentley's, which sells 500 to 600 of them a week; out of about 10,000 total weekly oyster sales, around 3,000 are native, although they make up only a quarter of the list. "Kellys are one of the most intense sea experiences you can have, the best of the best, the beluga caviar of the oyster world," says Fiorillo. "They're not profitable; they're on the menu for prestige." Ⓑ

Easing The Daily Grind

Pepper grinders are famously frustrating. Männkitchen's canon promises swifter spicing

By Matthew Kronsberg
Photograph by Kerri Brewer

If it didn't come with a wink and a good dose of humor, the machismo—or, for that matter, the $200 price tag—of the Männkitchen Pepper Cannon might leave a bad taste in your mouth. Fortunately, the only thing you'll be left tasting is pepper, and lots of it. Ferociously efficient, it can grind a quarter of a cup of peppercorns in just a few minutes. The body is milled from a solid chunk of aircraft-grade aluminum and anodized to a matte jet-black finish. Inside, high-carbon stainless-steel burrs grind mightily, and it takes fewer turns of the head to produce more pepper than other mills. (It worked four times as fast, in our tests.) At 7.25 inches tall, the 1-pound cannon is both understated and imposing—a tool for those who take their spices and cooking seriously.

THE COMPETITION

- Although the body of the Nantucket, Massachusetts-made Unicorn Magnum grinder ($49) is ABS plastic rather than aluminum, its performance is on par with the Pepper Cannon's.
- The $60 Zwilling Enfinigy electric mill contains a ceramic grinder, allowing it to handle a range of spices and large crystals of salt without corroding. The lithium-ion battery also powers a small light that illuminates your food for precision seasoning.
- Peugeot's $125 Roellinger pepper mill, designed in collaboration with French restaurateur and spice merchant Olivier Roellinger, has a speedy hand crank and small drawer to collect the grindings.

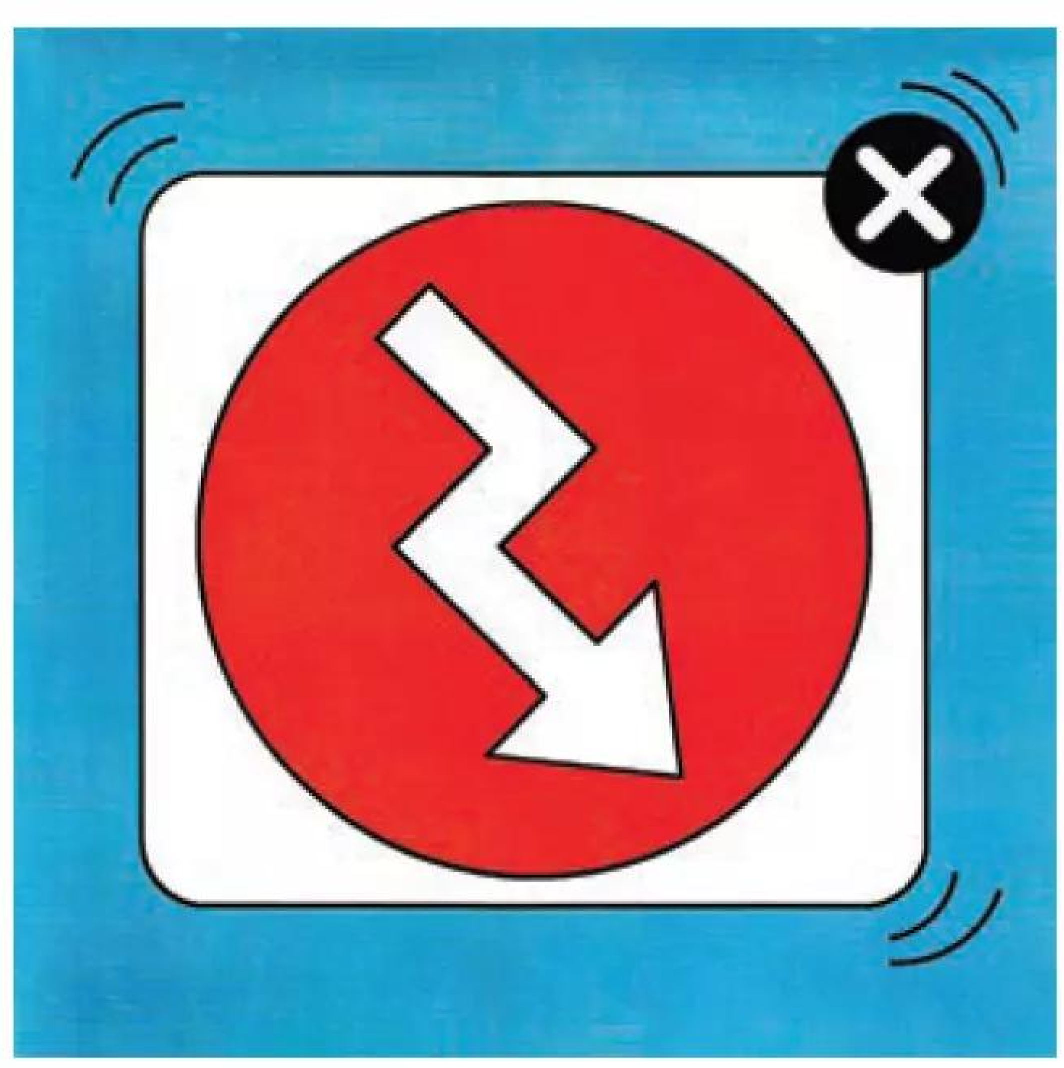
THE CASE

Little details on the Pepper Cannon, like a quick-release button (available in black, red or silver) to pop the top for easy refilling, make it anything but run of the mill. Grind size, highly adjustable from a coarsely cracked 8 mesh down past an ultrafine 60 mesh, is impressively consistent. For recipe prep, an aluminum cup screws onto the bottom and can hold a third of a cup of ground pepper. Founder Cleve Oines, whose grandparents immigrated to Alaska from Norway, says the company's name is a portmanteau of the word for "my" in an Old Norse dialect and, obviously, "kitchen." *$200; mannkitchen.com*

Buzzfeed News Was More Blockbuster Than Netflix

By Alex Webb

BuzzFeed Inc., befitting a media company bred for virality, always meant many things to many people: listicles, charticles, investigations, quizzes and “15 Poop Horror Stories That Will Make You Feel Better About Yourself.” It was a fire hose of award-winning news and digital pablum.



And on April 20, BuzzFeed leaders excised its award-winning news.

In its prime, *BuzzFeed News* had formidable reporters across the board, its efforts culminating in a 2021 Pulitzer Prize for its reporting on China’s detention of Muslims in Xinjiang province. The publication’s demise has prompted sneering aplenty. But for all of BuzzFeed’s missteps under Chief Executive Officer Jonah Peretti—it burned through hundreds of millions of dollars—it was a trailblazer. When social media replaced physical newsstands as the main distributors of news, BuzzFeed’s distinctive headline-writing and its videos’ visual language pioneered ways to lure an audience.

For a brief, heady moment, plenty imagined that BuzzFeed would be to news media what Netflix was to film and television: a disruptive business model plotting a path for others. In reality, it was more like Blockbuster Video.

Netflix attracts subscribers with a few big-ticket productions, then hopes they stick around for the lower-quality fare that plumps up its catalog. Blockbuster made money only when someone decided to rent a given DVD or VHS. BuzzFeed is similar: Each story, video and listicle has to find its own audience in the competitive social media market to make money from ads. It relies on social media for traffic and advertising for revenue. Should the whims of either change—and they did—then the company feels the pain.

The likes of New York Times Co. have recognized that social media is the top of a funnel that ultimately results in someone paying for a subscription. Times Co. now makes 67% of revenue from subs and just 23% from ads. BuzzFeed still depends on ads for half its sales, and subscriptions would be a harder sell given the nature of its output.

BuzzFeed’s decline doesn’t, however, represent the triumph of news subscriptions, because subscribers are getting harder to find. Social media platforms now have little interest in sending traffic to a website that isn’t paying for an ad. Facebook used to make it pretty easy to click on articles, even those produced by a Moldovan content farm. On TikTok, you’re not clicking on anything much at all, just swiping up to the next video. And Elon Musk seems intent on scorning news organizations on Twitter.

Some 39% of 18- to 24-year-olds declared social media their main news source last year, versus 34% who went to news websites or apps, according to the Reuters Institute for the Study of Journalism. BuzzFeed won’t abandon news entirely—it still owns *HuffPost*, the news aggregator it acquired in 2020, which depends less on social traffic. But the death of its news arm shows that finding a monetizable audience on social media is only becoming harder. Ⓑ

ILLUSTRATION BY GEORGE WYLESOL

Bloomberg Businessweek (USPS 080 900) May 1, 2023 (ISSN 0007-7135) H Issue no. 4781 Published weekly, except one week in February, April, May, June, July, August, September, October and November by Bloomberg L.P. Periodicals postage paid at New York, N.Y., and at additional mailing offices. Executive, Editorial, Circulation, and Advertising Offices: Bloomberg Businessweek, 731 Lexington Avenue, New York, NY 10022. POSTMASTER: Send address changes to Bloomberg Businessweek, P.O. Box 37528, Boone, IA 50037-0528. Canada Post Publication Mail Agreement Number 41989020. Return undeliverable Canadian addresses to DHL Global Mail, 355 Admiral Blvd., Unit 4, Mississauga, ON L5T 2N1. Email: contactus@bloombergsupport.com. QST#1008327064. Registered for GST as Bloomberg L.P. GST #12829 9898 RT0001. Title registered in the U.S. Patent Office. Single Copy Sales: Call 800-635-1200 or email: bwkcustserv@cdsfulfillment.com. Educational Permissions: Copyright Clearance Center at info@copyright.com. Printed in the U.S.A. CPPAP NUMBER 0414N68830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